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## Improving Charitable Accountability

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# IMPROVING CHARITABLE ACCOUNTABILITY

JAMES J. FISHMAN\*

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## INTRODUCTION

The tax-exempt sector is at a watershed; the way it is perceived by the public is changing. Nonprofit organizations and their executives have succumbed to widely publicized recent scandals that one might expect from the business world or criminal enterprises.<sup>1</sup> Charitable

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1. One such scandal involved the United Way of America, a seminal development concerning fraud. *See* *Aramony v. United Way*, 28 F. Supp. 2d 147, 152-53 (S.D.N.Y. 1998) (adjudicating various claims and counterclaims in a case that arose from the actions of William Aramony, the long-time president and chief executive officer of the United Way of America, who for his own personal gain, engaged in criminal activities for which he was convicted and sentenced to seven years in prison), *aff'd in part and rev'd in part*, 86 F. Supp. 2d 199 (2d Cir. 1999). Another scandal involved Dr. Lorraine E. Hale, the director of Hale House, a well-known charity that provides shelter for babies born to drug-addicted mothers, who was sentenced to probation after having admitted to stealing the charity's funds. John J. Goldman, *Charity Ex-Chief Admits to Theft*, L.A. TIMES, July 4, 2002, at A12. In that case, Hale, along with her husband, admitted to stealing approximately \$700,000 from Hale House, *id.*, which was found to not have had "a 'legally constituted' board of directors," Terry Pristin, *Co-Founder of Hale House is Dismissed with a Stinging Rebuke*, N.Y. TIMES, May 18, 2001, at B2.

Other scandals have involved: the American Red Cross, David Barstow, *A Nation Challenged: The Charities; In Congress, Harsh Words for Red Cross*, N.Y. TIMES, Nov. 7, 2001, at B1 (summarizing the criticisms of members of Congress levied against the American Red Cross for the organization's decision to keep almost half of the charitable donations it received for September 11 victims in reserve); the Foundation for New Era Philanthropy, *New Era Founder Indicted on 82 Counts*, L.A. TIMES, Sept. 28, 1996, at D2 (explaining that the founder of the foundation was indicted because he had allegedly bilked charities and philanthropists out of approximately \$350 million by promising them that their "investment"

organizations serve a public purpose and the misuse of tax-exempt funds imposes an injustice upon the community.<sup>2</sup> As nonprofits increasingly resemble their for-profit counterparts or engage in inappropriate or illegal activity, the halo effect of having tax-exempt status becomes tarnished. For-profit versions of traditional nonprofit activities, such as health care and education, and conversions from the non-profit firm to the for-profit firm have blurred the difference between eleemosynary activity, with its rationale for special treatment, and for-

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would be doubled in six months by anonymous benefactors who did not exist); the Bishop Estate, JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 215-17 (2d ed. 2000) (discussing the forced removal of the trustees of Hawaii's Bishop Estate, an affluent charitable trust, due to "financial impropriety, excessive compensation, and conflicts of interest"); Common Fund, Peter Truell, *Investment Fund for Colleges Says Trader Caused \$128 Million Loss*, N.Y. TIMES, July 1, 1995, § 1, at 1 (describing the approximately \$128 million in losses caused by a rogue trader at a fund which oversaw nearly \$20 billion of endowment for a consortium of educational institutions and in which the colleges were unaware of the risk and unable to limit such losses); Adelphi University, *Comm. to Save Adelphi v. Diamandopoulos* (Bd. of Regents Feb. 5, 1997), at <http://www.regents.nysed.gov/adelphi.html> (last visited Oct. 3, 2002) (recommending that the president of Adelphi University, who in 1995-96 was receiving a compensation package valued at approximately \$837,113, a luxury Manhattan apartment, a Mercedes, and a lavish expense account all while the university was losing its student base, should be removed from office); Arizona Baptist Foundation, Randall Smith, *Loss-Plagued Baptist Foundation of Arizona Undergoes Investigation by Regulators in State*, WALL ST. J., Sept. 1, 1999, at C1 (discussing the loss of close to \$100 million by the Baptist Foundation of Arizona through risky investments); and the Allegheny Health, Education, and Research Foundation, Scott Hensley, *AHERF Executives Arrested; Pa. Attorney General Says Three Stole Endowment Funds*, MODERN HEALTHCARE, Mar. 20, 2002, at 2 (reviewing the allegations against the executives of the health foundation, which included using \$52.4 million in foundation funds for such things as illegal political contributions and tickets to sporting events).

In addition to insider actions, criminal elements will also occasionally use nonprofit organizations as vehicles for illegal activity. See Timothy Egan, *After the Attacks: The Profiteers; A Tragedy Spawns Charity Fraud and Price Gouging at the Gasoline Pumps*, N.Y. TIMES, Sept. 15, 2001, at A14 (reporting that phony telephone solicitors claiming to be collectors for Red Cross were calling individuals in the period after September 11); Judith Miller, *U.S. Contends Muslim Charity is Tied to Hamas*, N.Y. TIMES, Aug. 25, 2000, at A21 (reporting on the State Department's accusation that the Holy Land Foundation for Relief and Development is affiliated with a terrorist organization); Terry Pristin, *Inquiries on Mortgage Deals Crimp Harlem's Realty Boom*, N.Y. TIMES, Nov. 26, 2000, § 1, at 1 (describing a scheme in which real estate speculators used nonprofit organizations to fraudulently obtain housing rehabilitation funds).

2. This statement assumes that the tax exemptions and charitable deductions are government subsidies to nonprofit organizations and their donors, or in tax parlance "tax expenditures." See 2 U.S.C. § 622(3) (2000) (defining tax expenditures as "revenue losses attributable to . . . exclusion, exemption, or deduction from gross income which provide a special credit, a preferential rate of tax, or a deferral of tax liability"). In other words, a tax exemption represents an underground stream of funds out of the U.S. Treasury. See *Regan v. Taxation with Representation*, 461 U.S. 540, 544 (1983) (explaining that "[b]oth tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.").

profit activity.<sup>3</sup> Virtually all nonprofits have emulated for-profit firms in their efforts to generate earned income.<sup>4</sup> Furthermore, these nonprofit commercial activities may or may not compete unfairly with their for-profit counterparts, but they surely duplicate some products and have some impact on the marketplace in which they compete.<sup>5</sup> At the least, this nonprofit commercial activity lessens the distinctions between the two sectors and creates new pressures for probity and accountability.

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3. It has been argued that the creation of the nonprofit sector is motivated by certain limitations of the market economy. Garry W. Jenkins, *The Powerful Possibilities of Nonprofit Mergers: Supporting Strategic Consolidation Through Law and Public Policy*, 14 S. CAL. L. REV. 1089, 1098 (2001). The nonprofit sector allows individuals to pool their resources to produce collective goods which the majority does not approve of, and where government will not step in. LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 12-13 (2d ed. 1999). Another justification for the nonprofit sector is:

“contract failure”—that is, situations in which, owing either to the nature of the service in question or to the circumstances under which it is produced and consumed, ordinary contractual devices in themselves do not provide consumers with adequate means for policing the performance of producers. In such situations, the nonprofit form offers consumers the protection of another, broader “contract”—namely, the organization’s commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide.

Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 506-07 (1981).

Despite this specific need for the nonprofit sector, what if for-profit forms begin to compete with their nonprofit counterparts and there are no differences in delivery? With the enormous expansion of cable channels and the resulting programming needs, is there a need still for public television? Is the broadcast of a Rolling Stones concert on public television any different from a similar broadcast on MTV? The latter sometimes may have less intrusive advertisements than constant appeals for funds. Would not other stations pick up virtually all public television programming? Is the survival of the Corporation for Public Broadcasting therefore the result of politics rather than need? See Irvin Molotsky, *One Tough Bird, After All; How Public Broadcasting Survived the Attacks of Conservatives*, N.Y. TIMES, Nov. 27, 1997, at E1 (describing the unsuccessful attempt by Congressional Republicans to shut down public broadcasting). For small business owners, the competition is more direct. In New York City, for-profit theaters such as the Quad Cinema compete against nonprofit theaters such as the Film Forum for the same independent films. Edward Lewine, *New Yorkers & Co.; The War of the Film Worlds*, N.Y. TIMES, Dec. 7, 1997, § 14, at 4.

4. Lewine, *supra* note 3.

5. Compare Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 634-35 (1989) (concluding that the Unrelated Business Income Tax (UBIT), I.R.C. § 511 (2000), should only be subjected to moderate reforms despite allegations by for-profit businessmen that it is causing them to have to unfairly compete with nonprofit firms), with Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1038 (1982) (asserting that the UBIT causes nonprofits to narrow the breadth of their profitmaking activities and thus to impose losses on the competitive for-profit firms that are operating in the same sectors).

This Article focuses upon a persistent problem of the nonprofit sector—its lack of accountability to the public.<sup>6</sup> Director, officer, and organizational responsibilities will be analyzed. Past and current approaches to secure accountability of charitable assets will be discussed, and a proposal for improving charitable accountability will be suggested through the creation of public-private charity commissions at the state level under the aegis of the attorney general.

## I. THE NONPROFIT LANDSCAPE: FORMS OF ORGANIZATION

Like their for-profit counterparts, nonprofit organizations are governed by a variety of legal regimes. Organization and governance are primarily matters of state law. Most states have enacted distinct statutes for nonprofit organizations that address the mechanics of formation, operational issues, structural changes such as mergers and conversion to for-profit status, dissolution, the oversight role of the state attorney general, and most important for the purposes of this Article, fiduciary obligations and liabilities of officers and directors.<sup>7</sup>

Nonprofit organizations have long been exempt from taxation at all levels of government.<sup>8</sup> Though there are over twenty categories of tax-exempt organizations,<sup>9</sup> the most desirable is Internal Revenue Code (I.R.C.) section 501(c)(3).<sup>10</sup> Organizations that qualify as chari-

6. Some scholars have raised a more basic issue—whether nonprofits are accountable to anyone, and if so to whom? See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465-66 (1996). For a recent critical report on nonprofit accountability see U.S. GEN. ACCOUNTING OFFICE, REPORT NO. GAO-02-526, *TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES* (2002) [hereinafter *GAO REPORT*].

7. See, e.g., CAL. CORP. CODE §§ 5000-10840 (West 1990 & Supp. 2002) (providing California's statutes that regulate nonprofit corporations).

8. See GARETH JONES, *HISTORY OF THE LAW OF CHARITY 1532-1827*, at 5 (1969) (noting that “[m]any privileges were granted to the charitable legacy which were denied to the private legacy”).

9. See I.R.C. § 501(c)-(d).

10. Section 501(c)(3) encompasses organizations:

organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

I.R.C. § 501(c)(3). No substantial part of a section 501(c)(3) organization's activities may consist of certain actions aimed at influencing legislation. *Id.* The organization also cannot participate or intervene in “any political campaign on behalf of . . . any candidate for public office.” *Id.* These organizations are often termed “public benefit” nonprofits, as compared to “mutual benefit” nonprofits, such as trade associations, that focus upon their “members.” See REVISED MODEL NONPROFIT CORP. ACT xxiv-xxix (1988).

table under this section are eligible to receive tax deductible contributions.<sup>11</sup> The body of federal fiscal law is considerable and complex and has an increasing tendency to influence and shape state fiduciary principles.<sup>12</sup>

To be eligible to receive tax deductible contributions under section 501(c)(3) of the Internal Revenue Code, nonprofit organizations can be formed as trusts, unincorporated associations, community chests, funds, foundations, or nonprofit corporations.<sup>13</sup> One of the odd aspects of nonprofit accountability is that the standard of accountability depends upon the form of organization chosen and whether the regulator is at the state or federal level.<sup>14</sup> For some nonprofit organizations the source of accountability lies in the law of trusts. For others the origin lies in corporate law. Within the corpus of trust or corporate law, the legal consequences may differ from other bodies in that organizational form.<sup>15</sup> For instance, the beneficiaries of private trusts have standing to correct fiduciary breaches, but the beneficiaries of charitable trusts are typically the public and lack standing to sue.<sup>16</sup> On the for-profit side, the demands of profitability, shareholders, capital markets, investment analysts, and looser standing requirements provide incentives for directors to perform as they should.<sup>17</sup> The narrowness of standing in the nonprofit sector, however, restricts the number of potential sentries of nonprofit behavior and places accountability in the hands of understaffed regulators.<sup>18</sup>

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11. See I.R.C. § 170(a)(1) (permitting deduction of charitable contributions); *id.* § 170(c)(2)(B) (qualifying a gift to a § 501(c)(3) corporation or other organization as a charitable contribution). Section 170(c)(3) of the Internal Revenue Code together with section 170(a)(1) permit taxpayers to deduct contributions to veterans organizations that qualify for tax exemption under section 501(c)(19), but section 501(c)(3) remains the most desirable category for other nonprofits.

12. Apart from taxes, nonprofit organizations are subject to various other forms of regulation ranging from antitrust to securities law. See Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 824-25 (1989).

13. I.R.C. § 501(c)(3).

14. See generally Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593 (1999) (noting the roles of state regulators, their federal counterparts, and shareholders in shareholder derivative suits).

15. *Id.* at 595-96.

16. See *id.* at 624 (observing that most states restrict standing in these cases to the state attorney general).

17. *Id.* at 525-26.

18. *Id.* at 623-24.

### A. Charitable Trusts

The existence of the charitable trust, as the oldest form of non-profit entity, predates the Statute of Charitable Uses of 1601 back to the fourteenth century.<sup>19</sup> "A charitable trust is a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it."<sup>20</sup> The trustee, as the person who holds the trust property is subjected "to equitable duties to deal with the property for a charitable purpose."<sup>21</sup> Charitable trusts are distinct from private trusts. The object of charitable trusts is to benefit the community rather than private individuals. Charitable trust assets must be dedicated exclusively and irrevocably to the objectives of that trust.<sup>22</sup> Charitable trusts are enforced by the attorney general and not the trust's beneficiaries,<sup>23</sup> and are not subject to the rule against perpetuities, and are therefore of unlimited duration.<sup>24</sup>

The charitable trust remains the predominant form of charitable organization in England,<sup>25</sup> although it has a less consistent existence in the United States.<sup>26</sup> Charitable trusts are appropriate for guarding property for charitable purposes and are often used for private foundations engaged exclusively in making grants.<sup>27</sup> The charitable trust form provides: ease and swiftness of formation, administration, and maintenance compared to the corporate form, choice of longevity, and the option of perpetual control by the grantor.<sup>28</sup> In addition, a charitable trust may be less costly to maintain than a nonprofit corporation.<sup>29</sup>

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19. GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 321 (rev. 2d ed. 1992); see also BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 5.1, at 86 (7th ed. 1998) (noting that the Statute of Charitable Uses of 1601 derived the definition of charitable purposes from English chancery law, as well as earlier civilizations and cultures). Exempt organizations such as churches existed far back into antiquity.

20. RESTATEMENT (SECOND) OF TRUSTS § 348 (1959).

21. *Id.*

22. FISHMAN & SCHWARZ, *supra* note 1, at 86.

23. RESTATEMENT (SECOND) OF TRUSTS § 379 cmt. a.

24. See 4A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* §§ 348.1, 365 (4th ed. 1989).

25. James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 620 (1985) (citing MARION R. FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 18-27 (1965)).

26. See *id.* at 624-29 (finding a historical reluctance on the part of American courts, including the Supreme Court, to uphold the validity of charitable trusts).

27. FISHMAN & SCHWARZ, *supra* note 1, at 62.

28. *Id.*

29. *Id.*



The mechanics of the charitable trust are governed by the charitable trust instrument, which: "names the trustees[; provides the charitable objective;] establishes policies for administration, distribution of assets and dissolution[;] names successor trustees or method of selection[;] and states the duration of the trust."<sup>30</sup> The trustees are responsible for management of the charitable trust.<sup>31</sup> The trustees "may be selected by the settlor or, in certain instances, judicially appointed, and may be self-perpetuating if the trust instrument so provides."<sup>32</sup>

### B. *Nonprofit Corporations*

Nonprofit corporations are governed by a board of directors.<sup>33</sup> In contrast to the charitable trust under which fiduciary responsibilities are governed under the restrictive and demanding principles of trust law, nonprofit corporate law is primarily influenced by the more lenient standards of business corporate law.<sup>34</sup> While the differences provide flexibility for nonprofit corporations and their boards, they also create problems, because the boundaries between appropriate and impermissible behavior are not always clear. Nor are the statutes at the state or federal levels models of clarity.

The nonprofit corporation is the predominant form of exempt organization in the United States.<sup>35</sup> The nondistribution constraint of the nonprofit corporation distinguishes it from the business corporation.<sup>36</sup> While this constraint does not preclude nonprofit corporations from earning a profit, it does prevent them from distributing any net profits to their members,<sup>37</sup> who are tantamount to corporate

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30. *Id.* Charitable trusts can be indefinite in duration unless the grantor has reserved a right of revocation or power to modify. 4 SCOTT & FRATCHER, *supra* note 24, § 367.

31. RESTATEMENT (SECOND) OF TRUSTS § 348 cmt. a (1959); Harry G. Henn & Michael George Pfeifer, *Nonprofit Groups: Factors Influencing Choice of Form*, 11 WAKE FOREST L. REV. 181, 202 (1975).

32. Henn & Pfeifer, *supra* note 31, at 202 (footnotes omitted).

33. FISHMAN & SCHWARZ, *supra* note 1, at 64.

34. *See id.* (noting the lower standard of care owed by nonprofit corporation directors as compared to charitable trustees).

35. *See* Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, PROB. & PROP., May/June 1989, at 32 (noting that "the corporate form is used most frequently when creating a museum, hospital, school or other charitable organization which will be open to the public on a regular basis").

36. N.Y. NOT-FOR-PROFIT CORP. LAW § 508 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT § 13.01 (1988). Consumer cooperatives, a specialized breed of nonprofit organizations, do permit dividend distributions to their members. Cooperative corporation statutes typically limit the purposes for which such corporations can be formed to ventures such as agricultural, housing, or medical activities. Hansmann, *supra* note 3, at 595-96.

37. N.Y. NOT-FOR-PROFIT CORP. LAW § 508; REVISED MODEL NONPROFIT CORP. ACT § 13.01 cmt.

shareholders in the nonprofit context. The nonprofit corporate form is advantageous in that its governing statutes are analogous to state corporate law.<sup>38</sup> This similarity provides a nonprofit corporation's legal counsel with a familial body of comparable case law that can be applied to the nonprofit context.

The charitable corporation, compared to the unincorporated association<sup>39</sup> or charitable trust, must adhere to more formalities in its creation and dissolution, but greater flexibility exists in its internal governance, making the charitable corporation more responsive to circumstantial changes such as the resignation or death of a director. A corporation can simply hold new elections while a change of a charitable trust organization's trustee may require application to a court.<sup>40</sup> The charitable corporation can amend corporate governing instruments with greater flexibility.<sup>41</sup> Similar to other corporate entities, the charitable corporation can sue and be sued, contract, and hold property in its own name. It has an indefinite existence, with the board of directors acting as its centralized management.<sup>42</sup> However, nonprofit corporation directors are held to a lower standard of care than charitable trustees;<sup>43</sup> directors benefit from limited liability.<sup>44</sup>

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38. FISHMAN & SCHWARZ, *supra* note 1, at 63.

39. Nonprofit tax-exempt organizations also can be unincorporated associations, an informal form of organization that involves "nothing more than two or more persons organized for a common purpose." *Id.* at 61. Relatively few nonprofits have adopted this form of organization.

40. Compare REVISED MODEL BUS. CORP. ACT § 8.03 (1999), with RESTATEMENT (SECOND) OF TRUSTS § 107 (1959).

41. However, corporate flexibility is not unlimited. In *Alco Gravure, Inc. v. Knapp Foundation*, the court held that directors of a not-for-profit corporation did not have unlimited power of amendment as to how assets were to be administered or to effectuate a transfer of assets on dissolution of a nonprofit corporation where amendment would have changed the purpose for which funds were given to the corporation. 479 N.E.2d 752, 756 (N.Y. 1985). Many features of corporate flexibility, such as the ability to delegate to officers and agents and amending rules of procedure, can be incorporated in a trust by "carefully drafted powers in the governing trust instrument." See Clark & Troost, *supra* note 35, at 32.

42. See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1288 (2001) (explaining that "the central features of the corporate form—fictitious entity status and limited liability of investors, indefinite existence, centralized management, and transferable share interests—make that form an extremely efficient way to aggregate the large pools of capital that are essential to finance large scale enterprise").

43. See *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974) (stating that "a trustee is uniformly held to a higher standard of care and will be held liable for simple negligence, while a director must often have committed 'gross negligence'").

44. See Gary, *supra* note 14, at 606 (providing that "in addition to the protection for directors provided by the business judgment rule, many states permit corporations to include a provision in the articles of incorporation limiting director liability under the duty of care").

Nevertheless, no matter what the form of organization, a primary concern of regulators at the state and federal levels is with the behavior of its fiduciaries.<sup>45</sup>

## II. THE LEGAL FRAMEWORK OF ACCOUNTABILITY

### A. *The Fiduciary Principle*

Directors and officers of nonprofit organizations are fiduciaries.<sup>46</sup> A fiduciary is one who acts for the benefit of another.<sup>47</sup> A fiduciary relationship involves a duty on the part of the fiduciary to act for the benefit of the other party to the relation as to matters within the scope of the relationship.<sup>48</sup> The “entrustor” in a fiduciary relationship is dependent upon the fiduciary,<sup>49</sup> and the fiduciary may not profit at the expense of the beneficiary unless she makes full disclosure of all circumstances surrounding a transaction.<sup>50</sup> In a real sense, a fiduciary is her brother’s keeper.

A fiduciary relationship is a description of an affiliation, but not an absolute test as to whether fiduciary obligations will be demanded. Relationships in which fiduciary obligations have been imposed possess three general characteristics: (1) the fiduciary has the “scope for the exercise of some discretion or power; (2) that power or discretion can be exercised unilaterally so as to effect [sic] the beneficiary’s legal or practical interests; and, (3) a peculiar vulnerability to the exercise of that discretion or power.”<sup>51</sup>

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45. Allen et al., *supra* note 42, at 1289-90.

46. See Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 632 (1998).

47. BLACK’S LAW DICTIONARY 625 (6th ed. 1990) (defining fiduciary as “[a] person having [a] duty, created by his undertaking, to act primarily for another’s benefit in matters connected with such undertaking”).

48. *Id.*; see also RESTATEMENT (THIRD) OF TRUSTS § 2 (Tentative Draft No. 1, 1996) (describing the nature of a fiduciary relationship within a trust). The fiduciary cannot profit at the expense of the beneficiary and must disclose all relevant information or circumstances or the transaction can be set aside. BOGERT & BOGERT, *supra* note 19, § 1, at 5 (stating “[a] fiduciary relation is one in which the law demands of one party an unusually high standard of ethical or moral conduct with reference to another”).

49. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800 (1983).

50. RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b (explaining that “if the fiduciary enters into a transaction with the other and fails to make full disclosure of all relevant circumstances known to the fiduciary, or if the transaction is unfair to the other, the transaction can be set aside by the other”).

51. *Hodgkinson v. Simms*, [1994] S.C.R. 377, 379.

1. *Trust Fiduciaries.*—The word “fiduciary” is frequently used in the context of a trustee of a trust or one who holds anything in trust.<sup>52</sup> In the trust setting, a fiduciary or one with a fiduciary obligation has a confidential relationship with another and is under a duty to act for the benefit of another as to matters within the scope of the fiduciary relationship.<sup>53</sup> The fiduciary cannot profit at the expense of another, whether a beneficiary or a charity.<sup>54</sup> When a fiduciary enters into a transaction with another and fails to fully disclose all pertinent circumstances, or if the transaction is unfair to the other, a court can set the transaction aside.<sup>55</sup>

The fiduciary obligation originated in equity, which granted relief “in numerous situations involving one person’s abuse of confidence reposed in him by another.”<sup>56</sup> Breach of trust comprised one of equity’s traditional jurisdictional realms.<sup>57</sup> Though the word “fiduciary” is commonly associated with the law of trusts, it has much broader use today.<sup>58</sup> The word “fiduciary” did not enter the English law reports until the mid-nineteenth century and was descriptive of relationships that resembled that between a trustee and beneficiary.<sup>59</sup> “Fiduciary” came from the Latin term “fiducia” meaning trust, and replaced “trust,” which came to have a more technical meaning.<sup>60</sup> This meant that other situations, such as confidences, which were similar in nature required another term, and “fiduciary,” an inadequate word itself, began to be used to encapsulate an indefinite series of relationships.<sup>61</sup> Since that time, there has been an enormous expan-

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52. “A trust . . . is a fiduciary relationship with respect to property, arising as a result of a manifestation of an intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of [another].” RESTATEMENT (THIRD) OF TRUSTS § 2.

53. *Id.* cmt. b.

54. *Id.*

55. *Id.*

56. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880.

57. L. S. Sealy, *Fiduciary Relationships*, 20 CAMBRIDGE L.J. 69, 69 (1962).

58. Originally, the concept was used for matters of confidence, which covers more than trusts whereby A had “confidence reposed in him by B not only where B had entrusted A with property to hold and deal with on behalf of himself or others.” *Id.* (emphasis added). Confidence could also be reposed where B is dependent on A’s advice because A was a trusted servant or friend or a person of dominant character or position. *Id.* “[M]any of these matters of confidence were naturally called ‘trusts’ whether there was any strict trust of property or not.” *Id.* at 70. In time, this looseness of phrasing gave rise to concrete rules. *Id.*

59. *Id.* at 71-72.

60. *Id.* at 72.

61. *Id.* 70-73 (stating “[t]he word ‘fiduciary,’ we find, is *not* definitive of a single class of relationships to which a fixed set of rules and principles apply”).

sion of fiduciary law into other areas of law and contexts reflecting basic changes in society.<sup>62</sup>

A fiduciary may be entrusted with a power that creates a risk that she will misuse the property or assets of the entrustor to the detriment of the beneficiary.<sup>63</sup> When a fiduciary does not misuse her power, the obligation goes against normal human behavior, because the fiduciary cannot act for herself or advance her own interest but can only further the interest of another.<sup>64</sup> There have been several theoretical justifications for the fiduciary obligation:<sup>65</sup> (1) voluntary assumption theory, whereby the fiduciary commits to act in another person's interest;<sup>66</sup> (2) entrusting theory, whereby the entrustor is dependent on the fiduciary;<sup>67</sup> (3) unjust enrichment theory, which describes the relief granted when a fiduciary has violated her duty;<sup>68</sup> and (4) dependency theory, in which the fiduciary relation looks to the relative positions of the parties and recognizes the beneficiary is at the mercy of the fiduciary.<sup>69</sup> Whatever the justification, a fiduciary obligation is a device that limits the discretion of the fiduciary to act in her own interest in a range of situations to which the law will harshly respond.<sup>70</sup> Once a fiduciary obligation is found, the law has imposed the highest standards of duty to assure that the beneficiaries' interests are kept in the forefront.<sup>71</sup>

There are generally three main types of fiduciary breach: (1) of the duty of loyalty involving a misappropriation of an asset or some-

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62. Frankel, *supra* note 49, at 795-98; *see also* Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 1 (1975) (noting that "[i]n the [last] two and a half centuries, the notion of the high standard incumbent on a fiduciary has spread from its original homeland in the law of trusts and has subjected a diverse variety of entrepreneurs—directors, partners, agents, employees—to its colonizing sway").

63. Frankel, *supra* note 49, at 809.

64. *Id.* (explaining that "[t]he power that the fiduciary obtains is originally vested in someone else, and is delegated to the fiduciary not for his own use, but solely for the purpose of facilitating the performances of his functions").

65. *See generally* DeMott, *supra* note 56, at 908-15 (discussing theoretical justifications for fiduciary obligation).

66. Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539, 540 (1949).

67. Frankel, *supra* note 49, at 800-01 (stating that "[b]y definition, the entrustor becomes dependent because he must rely on the fiduciary for a particular service").

68. Gareth Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 LAW. Q. REV. 472, 474 (1968). If a fiduciary is in breach of a duty of loyalty he must disgorge any benefit gained.

69. Weinrib, *supra* note 62, at 6-7.

70. DeMott, *supra* note 56, at 915.

71. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1047 (1991) (explaining that the duty of loyalty and the duty of care protect against misappropriation and negligent management of funds).

thing of value,<sup>72</sup> (2) of the duty of care consisting of the negligent attention to the beneficiaries' needs or estate,<sup>73</sup> and (3) of the duty of obedience, requiring compliance with the expressed purposes of the organization.<sup>74</sup>

Fiduciaries are also subject to common law duties, statutory mandates, and equitable rules or principles.<sup>75</sup> Thus, a fiduciary must collect and preserve property, but must not commingle it with her own assets; must not take incongruous or contrary actions despite instructions; and must keep beneficiaries informed.<sup>76</sup> The most fundamental duty of a charitable trustee or corporate fiduciary is loyalty to the beneficiary. The reasoning for the loyalty rule is that a person cannot serve two masters and act fairly toward both. The fiduciary's concern must be with the interest of the beneficiary whether it is a distinct individual or an inchoate body such as the public.<sup>77</sup> Because of the indefiniteness of the beneficiary class, the loyalty rule is designed to deter the fiduciary from the temptation of engaging in opportunistic behavior.<sup>78</sup> An action in good faith is not an excuse.<sup>79</sup>

The legal rules of trust fiduciaries stringently have prohibited the fiduciary from misappropriating the beneficiary's property and have held her liable for the mismanagement of the asset.<sup>80</sup> If a fiduciary has profited at the expense of the beneficiary or has advanced her

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72. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (citation omitted). Judge Cardozo described the fiduciary's duty of loyalty as follows:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honestly alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

*Id.*

73. Cooter & Freedman, *supra* note 71, at 1047.

74. Michelle Estrin Gilman, "Charitable Choice" and the Accountability Challenge: Reconciling the Need for Regulation with the First Amendment Religion Clauses, 55 VAND. L. REV. 799, 828 (2002).

75. BOGERT & BOGERT, *supra* note 19, §§ 541-544.

76. *Id.* § 541.

77. See Naomi Ono, *Boards of Directors Under Fire: An Examination of Nonprofit Board Duties in the Health Care Environment*, 7 ANNALS HEALTH L. 107, 111 n.23 (1998) (stating that boards of directors have similar duties "whether the beneficiaries are the shareholders or the public-at-large").

78. BOGERT & BOGERT, *supra* note 19, § 543.

79. *Id.* (stating "[g]ood faith on the part of the trustee is not a defense against a claim of disloyalty").

80. See RESTATEMENT (SECOND) OF TRUSTS § 198 (1959).

own interests, the gain will be treated as unjust enrichment and equity will demand that it be disgorged.<sup>81</sup> Upon a breach of the duty of care the fiduciary will be guilty of simple negligence. Primarily, trust law is concerned with preventing conflicts of interest by prohibiting, limiting, or supervising self-dealing and by placing the burden of proof upon the fiduciary to justify her actions.<sup>82</sup>

2. *Corporate Fiduciaries.*—Trustees of charitable trusts are generally held to stricter fiduciary norms of oversight than directors of nonprofit corporations.<sup>83</sup> Thus, the degree of legal accountability will depend upon the choice of form. If a nonprofit organization is incorporated, a board of directors exercises the corporate powers and directs the management in its activities.<sup>84</sup> The governance structures of nonprofit organizations resemble their profit seeking counterparts, as do the fiduciary standards of behavior.<sup>85</sup> Fiduciary corporate rules are much more flexible and relaxed than their trust analogs.<sup>86</sup>

The mandates of the legal rules mask a problem: they are difficult to apply in concrete situations. While some commentators have suggested that the fiduciary principle is “a standard form penalty clause,” a default or an “off-the-rack” rule that reduces transaction and enforcement costs,<sup>87</sup> courts are not loath to find a fiduciary relationship despite the intentions of the parties and, if there is a breach, they will impose a constructive trust.<sup>88</sup>

Once a person assumes a fiduciary obligation, a series of moral demands are placed upon her including “[l]oyalty, fidelity, faith, and honor.”<sup>89</sup> One of the problems for the fiduciary is that these standards are ambiguous, largely self-enforcing, and hardly reflective of normal human behavior. Often, the generality of fiduciary norms makes their application difficult.<sup>90</sup> In this area, as in so many others,

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81. Jones, *supra* note 68, at 472-74.

82. Frankel, *supra* note 49, at 824-25.

83. See FISHMAN & SCHWARZ, *supra* note 1, at 64. Although there are differing structures for trustees of charitable trusts and directors of nonprofit corporations, the terms “trustee” and “director” often are used interchangeably.

84. REVISED MODEL NONPROFIT CORP. ACT § 8.01 (1988).

85. See Gary, *supra* note 14, at 611-12 (noting that the Revised Model Nonprofit Corporation Act uses corporate style fiduciary duties for nonprofit corporation directors).

86. FISHMAN & SCHWARZ, *supra* note 1, at 63.

87. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702-03 (1982).

88. P.D. Finn, *The Fiduciary Principle*, in EQUITY, FIDUCIARIES AND TRUSTS 1, 23, 54 (T.G. Youdan ed., 1989).

89. Frankel, *supra* note 49, at 829-30.

90. See DeMott, *supra* note 56, at 879 (discussing how courts have historically relied on past cases in determining whether a fiduciary obligation exists in a particular case).

individuals with fiduciary responsibilities may deceive themselves into believing that they are upholding standards when in fact they are not. Sometimes they are simply following custom or are otherwise ignorant of the rules or of changes in fiduciary standards. Fiduciaries may cheat and act with proven dishonesty. As often, the fiduciary may not benefit, but the beneficiary is harmed through neglect. The fiduciary may have a pure heart and an empty head, being foolish but honest.<sup>91</sup>

### *B. The Duties of Care, Loyalty, and Obedience*

The duty of care applies to the standard of conduct required of directors in the discharge of their fiduciary duties.<sup>92</sup> It mandates that directors exercise their responsibilities "in good faith" and with a certain degree of diligence, attention, care, and skill.<sup>93</sup> Generally, a director can neglect her duty of care by failing to supervise the corporate entity, or even if the director is unprejudiced, independent, and acting in good faith, by neglecting to make an informed decision about a matter that comes before the board for action.<sup>94</sup>

The duty of care and a complementary principle, the business judgment rule, relate to the process of decision making. If a director acts in good faith, with the requisite degree of care, and within her authority, the director will not be liable for a decision, even if it proves disastrous to the organization.<sup>95</sup> Thus, the duty of care is concerned with the manner in which directors exercise their responsibilities, rather than a decision's correctness or benefit to the organization.

The duty of care has two components. The first is a process issue: did the directors act with insufficient care in reaching their decision?<sup>96</sup> The second question raises a substantive inquiry: was the decision so rash as to warrant being set aside or imposing personal liability

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91. Cf. Melvin Aron Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 590 (1984) (stating in reference to the corporate sector that "it may well be that the most important contemporary problem concerning managerial accountability is not the manager who consciously violates his trust, but the manager who does his best but whose best is not good enough").

92. REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1988).

93. *Id.* § 8.30(a)(1)-(2); see also CAL. CORP. CODE § 5231(a) (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (McKinney 1997).

94. James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701, 734 (1998).

95. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 399 (1987).

96. See *id.* at 400. The inquiry into whether a director violated her duty of care presupposes that the director made a reasonable inquiry and an informed decision. *Id.*



on the directors?<sup>97</sup> If the response to each component is negative, the director will be protected by the business judgment rule, or more accurately in a nonprofit setting, the best judgment rule.<sup>98</sup> The business judgment rule provides that directors shall not be liable for harm to the corporation for exercising their judgment so long as they exercise care.<sup>99</sup> This judgmental safe harbor only applies in the absence of fraud, illegality, or some disabling conflict of interest.<sup>100</sup>

The standard for a charitable trustee's duty of care once was as rigid as that of the private trust.<sup>101</sup> Under the *Restatement (Second) of Trusts*, "[t]he trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise with his own property."<sup>102</sup> The powers of delegation were quite limited.<sup>103</sup> Commencing with the Uniform Management of Institutional Funds Act (UMIFA) approved in 1972 by the National Conference of Commissioners on Uniform State Laws,<sup>104</sup> the standard of care became more flexible and applied similar standards to trustees of charitable trusts and nonprofit corporations.<sup>105</sup> Furthermore, UMIFA eased restrictions on investments under trust law by adopting a business judgment approach for director and trustee decisions in connection with investment decisions.<sup>106</sup> UMIFA's approval has been followed by the Uniform Prudent Investor Act,<sup>107</sup> the *Restatement (Third) of Trusts*,<sup>108</sup> and the Uniform Trust Code.<sup>109</sup> The *Restatement* has seemingly joined the duties of care of the trustees of a

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97. *See id.* A director has not violated the duty of care in a non-self-dealing transaction if the director could have rationally believed that the transaction was in the best interest of the corporation. *Id.*

98. *Id.*

99. Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 610-11 (1984).

100. *Id.*

101. Gary, *supra* note 14, at 597.

102. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). This was an obviously flawed standard as human nature suggests few people would exercise the same care for another as they would with their own property. *See Harden v. Parson*, 28 Eng. Rep. 639, 641 (Ch. 1758).

103. *See* RESTATEMENT (SECOND) OF TRUSTS § 171 (requiring a trustee not to delegate responsibilities that he could reasonably perform himself).

104. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT, 7A pt. II U.L.A. 475 (1999).

105. *See id.* § 6, 7A pt. II U.L.A. 500 (adopting the ordinary business care standard as the standard of conduct). The UMIFA applies to charitable organizations, regardless of whether the organization is incorporated. *Id.* § 1(1), 7A pt. II U.L.A. 484.

106. *Id.* § 6, 7A pt. II U.L.A. 500; *see also* Gary, *supra* note 14, at 601 (discussing UMIFA's investment restrictions).

107. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 286 (2000).

108. RESTATEMENT (THIRD) OF TRUSTS (Tentative Draft No. 1, 1996).

109. UNIF. TRUST CODE (amended 2002), 7C U.L.A. § 99 (Supp. 2002).

charitable trust and a director of a nonprofit corporation.<sup>110</sup> Section 227 states that a trustee should exercise such care and skill in administering the trust as an investor of ordinary prudence would exercise<sup>111</sup> language similar to the corporate duty of care.<sup>112</sup>

There have been differing degrees of care expected from nonprofit directors.<sup>113</sup> Since most directors are unpaid and serve out of a sense of civic duty, there is a reluctance to impose financial liabilities upon them.<sup>114</sup> One cannot make the position of director so legally burdensome that people will not join boards or will refuse to allow the organization to undertake risks. A tension exists between a desire to encourage competent and energetic people to serve on boards and society's need to assure that directors are accountable for the activities of public benefit nonprofits, whose rationale is to serve the community. Today, the dominant nonprofit standard of care is that applied to corporate directors.<sup>115</sup> A director of a nonprofit is supposed to discharge her duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation."<sup>116</sup>

Differing standards of the duty of loyalty have remained. Under the law of trusts the duty of loyalty is "perhaps the most fundamental duty of the trustee."<sup>117</sup> The rule against conflicts of interest between the trustee and the trust is absolute and a court may require any improper transactions to be unwound.<sup>118</sup> The standard of loyalty for directors of charitable corporations draws upon business corporate law. Directors must be loyal to the corporations on whose board they

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110. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (proposing a trust investment standard).

111. *Id.*

112. See REVISED MODEL NONPROFIT CORP. ACT § 8.30(a)(1)-(3) (1988).

113. See *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1015 (D.D.C. 1974) (explaining that in many jurisdictions a director must have exhibited gross negligence to be liable for negligent mismanagement of investments); *Lynch v. John M. Redfield Found.*, 88 Cal. Rptr. 86, 89 (Cal. Ct. App. 1970) (stating that a director's standard of care in executing a trust is that of a prudent man); *George Pepperdine Found. v. Pepperdine*, 271 P.2d 600, 604-05 (Cal. Dist. Ct. App. 1954) (finding that the joiner who endowed the foundation was not liable for lost foundation funds, which the court understood were lost through either ignorance or careless actions), *overruled en banc by Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964).

114. Fishman, *supra* note 95, at 407.

115. FISHMAN & SCHWARZ, *supra* note 1, at 176.

116. REVISED MODEL NONPROFIT CORP. ACT § 8.30(a)(1)-(3).

117. UNIF. TRUST CODE § 802 cmt. (amended 2001), 7C U.L.A. 101 (Supp. 2002).

118. Gary, *supra* note 14, at 598-99.

serve.<sup>119</sup> This requires them to act in a way that does not harm the corporation and places the corporation's needs ahead of their own interests.<sup>120</sup> The mandate of loyalty further requires directors to avoid using their positions to obtain personal benefits or advantages, which more properly belong to the corporation.<sup>121</sup> The fact that a director has an interest in a transaction is less important than whether the undertaking was fair to the corporation when the decision was made, and whether the decision was reached after full disclosure in an impartial board environment.<sup>122</sup> Directors should make decisions objectively, refrain from participating in decisions that benefit themselves, and obtain approval from the corporation's board if a relationship exists which might impair the director's objectivity.<sup>123</sup> If a director receives more favorable financial benefits than he could gain in the open market or enjoys priority over market competitors, a conflict of interest results.

Conflicts of interest, divided loyalties, and transactions between directors, officers, and charitable corporations commonly occur in the nonprofit sector.<sup>124</sup> "Breaches of loyalty are not only much easier to identify than breaches of care, they are much more prevalent."<sup>125</sup> Interested nonprofit transactions parallel business corporate practices and are bounded only by human ingenuity. Some frequent forms of interested transactions include: the use of an organization's property or assets on a more favorable basis than available to outsiders;<sup>126</sup> the taking of an opportunity that rightfully belongs to the corporation;<sup>127</sup> the use of material nonpublic organizational information or position;<sup>128</sup> and insider advantages and corporate waste.<sup>129</sup>

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119. See REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 4.

120. See *id.* § 8.30-.33 (setting forth general and specific aspects of a director's duty of loyalty).

121. FISHMAN & SCHWARZ, *supra* note 1, at 190.

122. *Id.*

123. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (1994).

124. See *supra* note 1 (providing examples of recent scandals involving charities).

125. Fishman, *supra* note 95, at 423-24.

126. See *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1078 (6th Cir. 1974) (explaining that a group of doctors were given preferential leases for office space); Gilbert M. Gaul & Neill A. Borowski, *Warehouses of Wealth: The Tax-Free Economy*, PHILA. INQUIRER, Apr. 22, 1993, at A1 (chronicling salaries and perks given to nonprofit directors including low interest and no interest loans).

127. See *Northeast Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146, 1146-47 (Me. 1995) (discussing the actions of a golf club president who purchased adjoining land for herself without notifying the board of directors).

128. See Doreen Carvajal, *Ailey Building is Designed by Relative of Board Chief*, N.Y. TIMES, May 15, 2001, at E1 (reporting on a commission to construct a building for a dance troupe

Interested transactions are often a necessity for a nonprofit organization. They may provide access to resources unavailable in the marketplace. The financial status of the nonprofit organization may be so poor that credit, supplies, or services are unattainable. A loan of money, goods, or services may be obtainable only from a director, who is concerned with the organization's welfare. In other contexts, the interested transaction may be unethical or illegal and, therefore, violative of the director's duty of loyalty to the corporation and to the public.

When evaluating a conflict of interest, one should focus upon the procedural aspects of the transaction and upon its substantive nature. The procedural aspects relate to the way the transaction is approved by the board of directors on behalf of the corporation. Procedural inquiries include asking whether corporate procedures for interested transactions have been established and were they followed in the particular transaction; was the board environment impartial and objective at the time the decision was made; was information relating to the transaction fully disclosed by the interested parties to the relevant decisionmakers; and was the interest of the involved director fully disclosed to the relevant decisionmakers. Substantive factors in conflict of interest transactions include the fairness of the transaction to the corporation in terms of the consideration the corporation received, the frequency of interested transactions between directors and the organization, and the overall financial status of the organization in relation to the particular transaction.

The permissibility of an interested transaction depends upon its context and the director's motivations. A transaction which may be perfectly proper in one context may be inappropriate under slightly different circumstances. For instance, nonprofit organizations have been formed as successors to proprietary corporations, typically schools, hospitals, and nursing homes. The shareholder-directors of the proprietary organization become the directors of the nonprofit corporation. If the successor organization pays the proprietary organ-

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that had been awarded to the son-in-law of the troupe's chairwoman without any competition or public notice).

129. See *Illinois ex rel. Scott v. Silverstein*, 408 N.E.2d 243, 244 (Ill. App. Ct. 1980) (alleging that the directors of a museum mismanaged it and improperly sold a painting); *Mile-O-Mo Fishing Club, Inc. v. Noble*, 210 N.E.2d 12, 16 (Ill. App. Ct. 1965) (finding that the former president of the club breached his fiduciary obligation by purchasing property that the corporation had desired to purchase); *Kirtley v. McClelland*, 562 N.E.2d 27, 33-36 (Ind. Ct. App. 1990) (examining and upholding the trial court's decision that the director of an owner's association breached his fiduciary duty by buying and operating a cable system on his own at the exclusion of the owner's association).

ization a fair rental value for its property or reasonable compensation for the proprietary's assets, the interested transaction should be permitted. If the nonprofit successor serves the directors' own interests, assumes for-profit liabilities in a bailout context, or overpays the rental costs or purchases the assets at an inflated price, the transaction is impermissible self-dealing.<sup>130</sup>

Another responsibility of directors is to abide by the organization's purposes as expressed in the articles of association or certificate of incorporation.<sup>131</sup> This responsibility, termed the duty of obedience, resembles the trustee's duty to administer a trust in a manner faithful to the wishes of the creator.<sup>132</sup> Unless allowed by the law, nonprofit directors may not deviate in any substantial way from the duty to fulfill the particular purposes for which the organization was created.<sup>133</sup> The duty of obedience mandates that the board refrain from transactions and activities that are *ultra vires*, that is, beyond the corporation's powers and purposes as expressed in its certificate of incorporation.<sup>134</sup> Though the *ultra vires* doctrine has been emasculated in corporate law,<sup>135</sup> a director may still be subject to suit if the corporation has entered into or completed an *ultra vires* transaction.<sup>136</sup> Thus, the director must follow the purposes and powers expressed in the governing legal documents.<sup>137</sup>

Beyond obeying the organizational documents, a nonprofit corporation and its directors and officers have the responsibility to

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130. Fishman, *supra* note 95, at 424-25.

131. FISHMAN & SCHWARZ, *supra* note 1, at 230.

132. See SCOTT & FRATCHER, *supra* note 24, § 164.1.

133. DANIEL L. KURTZ, BOARD LIABILITY 84-85 (1988).

134. Gilman, *supra* note 74, at 828.

135. See REVISED MODEL NONPROFIT CORP. ACT § 3.04 cmt. (1988) (declaring that section 3.04's purpose is to eliminate the *ultra vires* doctrine).

136. *Id.* § 3.04(c).

137. In *Brown v. Memorial National Home Foundation*, the attorney general brought an action for declaratory relief as to conflicting claims to the assets of charitable trusts created for a patriotic organization. 329 P.2d 118, 120 (Cal. Dist. Ct. App. 1958). The evidence sustained a finding that the corporation, which had acquired funds in trust for the benefit of needy members of the organization and for the benefit of needy parents of servicemen who were World War II victims, could not repudiate the trusts by attempting to dedicate the property to different uses and exclusion of the patriotic organization. *Id.* at 124-30. The diversion of the funds to unauthorized purposes afforded grounds for removal of the trustee. *Id.* at 130. Similarly, in *Queen of Angels Hospital v. Younger*, the California Court of Appeal found that the hospital, whose articles of incorporation called for the use of its assets in the operation, could not forego "the hospital business in favor of [neighborhood] clinics." 136 Cal. Rptr. 36, 41 (Cal. Ct. App. 1977). Although various clauses of the articles of incorporation referred to plural purposes, the essential framework of the purposes clauses was the operation of a hospital. *Id.* at 40-41.

comply with the law.<sup>138</sup> Nonprofits are subject to several legal regimes ranging from federal and state tax laws, civil rights statutes, and anti-trust laws which affect all organizations.<sup>139</sup> Other statutes apply to specific types of organizations such as private foundations.<sup>140</sup> A director, officer, or trustee can be held responsible if an organization violates the law.<sup>141</sup> For example, a director or officer is liable for a corporation's failure to pay taxes if she meets the Internal Revenue Code's definition of "[responsible] person" and the failure to pay has been "willful."<sup>142</sup> Directors involved in day-to-day administration of the organization in matters related to taxes and financial records are "[responsible] persons."<sup>143</sup> Note that although directors are responsible for compliance with legal requirements in areas of obvious significance, such as payment of taxes, they are not responsible for technical compliance with every aspect of a regulatory regime.<sup>144</sup>

The duty of obedience often arises in the tax context. Organizations exempt from taxation under section 501(c)(3) of the Internal Revenue Code must be organized and operated exclusively for certain approved purposes.<sup>145</sup> "No part of the[ir] net earnings . . . [may] inure to the benefit of any shareholder or individual."<sup>146</sup> Restrictions on lobbying activities and prohibitions on intervention in political campaigns limit nonprofit activity.<sup>147</sup> If an organization is operated

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138. See N.Y. NOT-FOR-PROFIT CORP. LAW § 521 (McKinney 1997) (establishing liability of corporation for failure to comply with certain sections of the law); *id.* § 719 (establishing liability for directors for failure to comply with certain requirements). In *Committee to Save Adelphi v. Diamandopoulos*, the New York State Board of Regents also found that by omitting the president's salary from the annual informational tax return, Form 990, Adelphi University failed to comply with Internal Revenue Code reporting requirements. *Comm. to Save Adelphi v. Diamandopoulos* (Bd. of Regents Feb. 5, 1997), at <http://www.regents.nysed.gov/adelphi.html> (last visited Oct. 3, 2002). The University was fined, audited, and threatened with revocation of their tax-exempt status for repeated failure to file. *Id.* Furthermore, according to the Board of Regents, this was a duty of law compliance violation by the president. *Id.* The Regents also determined that Adelphi's board of directors had countenanced an almost complete breakdown of the University's governance structure as evidenced in its Articles of Governance, a duty of obedience violation. *Id.*

139. See BASIL FACCHINA ET AL., PRIVILEGES & EXEMPTIONS ENJOYED BY NONPROFIT ORGANIZATIONS: A CATALOG AND SOME THOUGHTS ON NONPROFIT POLICYMAKING (NYU Prog. Philanthropy & The Law, 1993).

140. See I.R.C. § 4940(a) (2000) (requiring private foundations to pay an excise tax on investment income).

141. *Id.* §§ 6671, 6672.

142. *Id.* § 6672(a).

143. See *id.* § 6671(c) (absolving certain board members in tax-exempt organizations from liability for violating the Internal Revenue Code).

144. FISHMAN & SCHWARZ, *supra* note 1, at 232.

145. I.R.C. § 501(c)(3).

146. *Id.*

147. *Id.*

primarily for non-exempt purposes, the directors have violated their duty of obedience.<sup>148</sup>

*C. Organizational Accountability Requirements: Record-Keeping and Filing Requirements*

The above responsibilities deal with the duties of individuals to fulfill their obligations to the organizations they serve. Organizations have responsibilities as well which generally consist of keeping mandated records and making them available or filing the documents with the appropriate regulator.<sup>149</sup>

To encourage accountability, or at least to enable investigators to determine whether the organization has expended its assets responsibly, most jurisdictions have created ongoing disclosure regimes requiring charitable organizations to maintain specified records and to file financial and other documents with appropriate governmental authorities on an annual basis.<sup>150</sup> Initially, when an organization seeks exemption from state taxation or seeks to incorporate, it will file its certificate of incorporation or articles of association with the appropriate agency. Typically, these are public documents.

*1. Organizational Records.*—The Revised Model Nonprofit Corporation Act requires a public benefit organization to maintain various corporate records: minutes of meetings and records of deliberations if taken without a meeting; appropriate accounting records; and membership lists.<sup>151</sup> In addition, an organization must prepare an annual report or financial statement.<sup>152</sup> Members have a right to inspect and copy an organization's records such as a membership list when such request "is made in good faith and for a proper purpose,"<sup>153</sup> and to receive an annual financial statement,<sup>154</sup> and di-

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148. Since the duty of obedience requires the directors to uphold the organization's founding documents, which require the organization to operate for a charitable purpose, operating for non-exempt purposes would be an *ultra vires* activity. See *supra* notes 131-137 and accompanying text (discussing the *ultra vires* doctrine).

149. See CAL. CORP. CODE §§ 6214, 6320-6323, 6330, 6333-6334, 6811-6814, 8320-8322 (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 519-522, 621 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT § 16.01-22 (1988).

150. See CAL. CORP. CODE §§ 6214, 6320-6323, 6330, 6333-6334, 6811-6814, 8320-8322; N.Y. NOT-FOR-PROFIT CORP. LAW §§ 519-522, 621; REVISED MODEL NONPROFIT CORP. ACT § 16.01-22.

151. REVISED MODEL NONPROFIT CORP. ACT § 16.01(a)-(c).

152. *Id.* § 16.22.

153. *Id.* § 16.02-.05.

154. *Id.* § 16.20.

rectors have the prerogative to inspect books and records.<sup>155</sup> However, many public benefit corporations are non-membership organizations, thereby eliminating one source of monitoring.<sup>156</sup>

2. *State Registration and Filing Requirements.*—State filing requirements differ and can become quite complex. Generally, organizations may have to register with the attorney general or another agency,<sup>157</sup> and file annual financial reports.<sup>158</sup> If a nonprofit organization intends to solicit funds from the public, over forty-five states require the organization to register, file financial reports, and in some cases register professional fundraisers.<sup>159</sup> Any oversight is likely to come from the public, for the documents submitted typically are not reviewed by the state authorities until and unless there has been a failure to file.<sup>160</sup>

New York law illustrates the filing burdens on nonprofits. All New York nonprofit organizations (except churches), which hold property or receive income to be used for charitable purposes, must register with the Charities Bureau of the New York State Law Department (the attorney general's office) within six months after they receive such property or income.<sup>161</sup> Thereafter, the organization must file an annual report with the attorney general within six months after the close of the fiscal year.<sup>162</sup> Organizations with unrelated business income must file an Unrelated Business Income Tax Report with the New York State Department of Taxation and Finance.<sup>163</sup> Annual financial reports and very detailed information concerning solicitation and the use of professional fundraisers also must be filed with the attorney general.<sup>164</sup> There also may be filings with local authori-

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155. *Id.* §§ 16.02-.03, 16.20.

156. *Id.* § 6.03. In a corporate business, the shareholders, as the owners of the firm, are monitors of management's accountability though this may be more theoretical than real. See Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 264-75 (2001) (discussing the role of shareholders in corporate law).

157. See CAL. GOV'T CODE § 12585 (West 1992); N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(d) (McKinney 2002).

158. See CAL. GOV'T CODE § 12586; N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(f)-(g).

159. See *Fundraising into the 1990s: State Regulation of Charitable Solicitation After Riley*, 24 U.S.F. L. REV. 571, 624-25, 634 (1990).

160. *Id.* at 651 n.513 (recognizing that states lack resources to closely monitor the charitable fundraising community).

161. N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(d).

162. *Id.* § 8-1.4(q)(1)-(2). Filing requirements differ depending on the income of the organization, see *id.* § 8-1.4(p) (listing filing fees), and whether professional fundraisers are used.

163. N.Y. TAX LAW § 292(a) (McKinney 1998).

164. N.Y. EST. POWERS & TRUSTS LAW § 8-1.4.



ties.<sup>165</sup> Organizations of any size will need the assistance of an accountant.

3. *Federal Filing Requirements.*—Organizations that have obtained recognition of exempt status from the Internal Revenue Service must file annual information returns on a Form 990.<sup>166</sup> The form must be filed by “the 15th day of the fifth calendar month following the close of the period for which the return is required.”<sup>167</sup> An organization need not file a Form 990 until it is recognized by the IRS as exempt.<sup>168</sup> Private foundations with assets of \$5000 or more must file an annual Form 990-PF information return.<sup>169</sup>

The Form 990 collects financial data mirroring in some ways audited financial statements.<sup>170</sup> However, the form does not disclose whether a nonprofit organization’s programs are efficient or effective. The form was not designed for that purpose. It began in 1942 as a two-page form and it enabled the Bureau of Internal Revenue to keep a list of all organizations held to be exempt to the end that the Bureau might occasionally inquire into their status and ascertain whether they were observing the conditions upon which their exemption was predicated.<sup>171</sup> However, the IRS and charity watchdog groups have raised substantial questions as to the accuracy of the information provided to

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165. Henn & Pfeifer, *supra* note 31, at 184 n.8.

166. Treas. Reg. § 1.6033-1(a) (2002). There are exceptions for churches, schools, certain other organizations, and organizations, other than private foundations, that normally have gross receipts of \$5000 or less in each taxable year. I.R.C. § 6033(a)(2) (2000).

167. Treas. Reg. § 1.6033-2(e).

168. *Id.* § 1.6033-1(c).

169. Organizations with \$1000 or more of gross income from an unrelated trade or business must file Form 990T. *Id.* §§ 1.6012-2(e), 1.6012-3(a)(5).

170. See Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571, 577 (1997) (noting that the Form 990 also facilitates state oversight of charitable organizations); Karyn R. Vanderwarren, *Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function*, 77 CHI.-KENT L. REV. 963, 969 (2002) (noting that the “Form 990 collects financial information, including details such as the organization’s five highest-paid employees, five highest-paid contractors, and fundraising expenses”).

171. See Marcus S. Owens, *Letter to the Editor*, CHRON. PHILANTHROPY, Sept. 7, 2000, at 31. Mr. Owens is a former Director of the Exempt Organizations Division of the Internal Revenue Service.

The GAO notes:

[The] 2-page form included only three yes/no questions, an income statement, and a balance sheet, although some line items required attached schedules. By 1947, the form (including instructions) had reached 4 pages, although some portions applied only to certain types of organizations. The required financial information was more extensive . . . . By 2001, the Form 990 had 6 pages (10 parts with 105 line items), 2 schedules . . . covering 13 pages, and a 45 page instruction book.

GAO REPORT, *supra* note 6, app. I at 38.

the IRS on Form 990 and its effectiveness in facilitating public oversight and evaluation of a charity's activity.<sup>172</sup>

### III. CHARITABLE ACCOUNTABILITY AND SOCIAL NORMS

Fiduciary accountability presents a paradox. The laws are abstract and offer little concrete guidance. As the number of nonprofit organizations has expanded enormously, enforcement efforts by regulators have declined, and there is little chance of legal sanctions for violations.<sup>173</sup> Increasing publicity about charitable scandals gives the impression that wrongdoing is widespread, yet most organizations and trustees abide by the rules, adhere to good practices, and demonstrate fidelity to the organization's mission and the eleemosynary ideal.<sup>174</sup> Many times trustees or organizations unfaithful to their trust are unknowingly unfaithful. Why is the level of fidelity so high? Why do most fiduciaries do what is right? The answer may be that most charitable fiduciaries have internalized the norms of appropriate behavior. Accountability is a normative issue that reflects the role of the non-profit sector in law and society.<sup>175</sup>

Norms are "informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, [or] because of a fear of external non-legal sanctions."<sup>176</sup> In recent years, legal scholars have examined the role of norms and their relation to law in a number of important articles.<sup>177</sup> This section attempts to apply

172. GAO REPORT, *supra* note 6, at 9-13.

173. See *infra* Part IV.A.2.f (describing obstacles to law enforcement).

174. But see Robert C. DeGaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance*, 36 CATH. LAW. 203, 230 (1995) (stating that "[t]he frequent occurrence of abusive dealings by organization insiders validates the widely-held belief that legislative reform is necessary and, indeed, inevitable").

175. Brody, *supra* note 6, at 465.

176. Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 340 (1997). Eric Posner has described a norm as "a rule that distinguishes desirable and undesirable behavior and gives a third party the authority to punish a person who engages in the undesirable behavior." Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1699 (1996).

177. See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841 (1996); Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643 (1996) [hereinafter Cooter, *Decentralized Law*]; Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998) [hereinafter Cooter, *Expressive Law and Economics*]; Robert Cooter, *Normative Failure Theory of Law*, 82 CORNELL L. REV. 947 (1997); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999); Jody S. Kraus, *Legal Design and the Evolution of Commercial Norms*, 26 J. LEGAL STUD. 377 (1997); Lawrence Lessig, *The Regula-*

some of the norms literature to the behavior of charitable fiduciaries.<sup>178</sup> Norms of fiduciaries are what Professor Melvin Aron Eisenberg terms moral obligational norms: rules or practices that actors not only consciously adhere to but feel obliged to do so for fear of self-criticism or criticism by others leading to shame.<sup>179</sup> Legal rules encompass norms and influence as well as change them.<sup>180</sup> The use of “norm” herein refers to behavior other than that expressly mandated by organizational rules.<sup>181</sup> Norms occur throughout society and range from the very abstract to the concrete.

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*tion of Social Meaning*, 62 U. CHI. L. REV. 943 (1995); McAdams, *supra* note 176; Richard H. Pildes, *The Destruction of Social Capital Through Law*, 144 U. PA. L. REV. 2055 (1996); Posner, *supra* note 176; Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133 (1996); Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. LEGAL STUD. 765 (1998); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996) [hereinafter Sunstein, *On the Expressive Function of Law*]; Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996) [hereinafter Sunstein, *Social Norms and Social Roles*].

178. For the application of norms theories to other areas of the law, see Robert D. Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, LAW & CONTEMP. PROBS., Summer & Autumn 1997, at 73 (punitive damages); Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT’L REV. L. & ECON. 215 (1994) [hereinafter Cooter, *Structural Adjudication*] (contract and commercial law); Eisenberg, *supra* note 177 (corporate law); Gertrud M. Fremling & Richard A. Posner, *Status Signaling and the Law, with Particular Application to Sexual Harassment*, 147 U. PA. L. REV. 1069 (1999) (sex discrimination); Steven Hetcher, *Creating Safe Social Norms in a Dangerous World*, 73 S. CAL. L. REV. 1 (1999) (torts); Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996) (criminal punishment); Dan M. Kahan & Eric A. Posner, *Shaming White Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365 (1999) (criminal punishment); Richard H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 HARV. L. REV. 1005 (1995) (anti-discrimination law); Richard H. McAdams, *Group Norms, Gossip, and Blackmail*, 144 U. PA. L. REV. 2237 (1996) (blackmail and privacy); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000) [hereinafter Posner, *Tax Compliance*] (tax law); Eric A. Posner, *The Legal Regulation of Religious Groups*, 2 LEGAL THEORY 33 (1996) (religion); Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998) (bankruptcy).

179. See Eisenberg, *supra* note 177, at 1257 (defining moral obligational norms).

180. See Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2026 (noting that “an appropriately framed law may influence social norms and push them in the right direction”).

181. For examples of organizational rules, see AM. ASS’N OF MUSEUMS, CODE OF ETHICS FOR MUSEUMS (2000), <http://www.aam-us.org/aamcoe.cfm> (last visited Oct. 2, 2002); COUNCIL OF BETTER BUS. BUREAUS, INC., CBBS STANDARDS FOR CHARITABLE SOLICITATIONS (1982), <http://www.give.org/standards/cbbbstds.asp> (last visited Oct. 2, 2002); MD. ASS’N OF NONPROFIT ORGS, STANDARDS FOR EXCELLENCE: AN ETHICS AND ACCOUNTABILITY CODE FOR THE NONPROFIT SECTOR (1998), <http://www.mdnonprofit.org/ethicbook.htm> (last visited Oct. 2, 2002); NAT’L ASS’N OF STATE CHARITY OFFICIALS, CHARLESTON PRINCIPLES: ON CHARITABLE SOLICITATION USING THE INTERNET (2001), [http://www.nasconet.org/stories/storyReader\\$10](http://www.nasconet.org/stories/storyReader$10) (last visited Nov. 25, 2002).

An initial force behind the creation of a norm is the desire individuals have for respect, esteem, or prestige from others.<sup>182</sup> Once a norm is established, people obey it in order to avoid being sanctioned by others (shame)<sup>183</sup> and in order to avoid being sanctioned by their conscience (guilt).<sup>184</sup> Stigma, which may occur if a norm is violated, provides a powerful incentive to follow the particular normative obligation. Thus, “[p]eople act in accordance with their perceptions of what other people think.”<sup>185</sup> According to Professor Richard McAdams, esteem produces the norm, and “internalization operates as a . . . reinforcing mechanism.”<sup>186</sup> Thus, violation of a social norm produces the expectation of shame, a heavy social tax, which will generate compliance.<sup>187</sup> Collectively, this process can achieve a social consensus on appropriate behavior.<sup>188</sup> Somebody who follows a norm signals that she is a good citizen—a cooperator.<sup>189</sup> One who flouts norms may present the opposite impression.<sup>190</sup> According to internalization theories, “an individual acquires a preference for conformity to a behavioral standard and suffers some psychological cost . . . when she fails to conform,” even if others are unaware of the breach.<sup>191</sup>

Organizations adopt normative behavior too. They “copy each other and adopt the standards dictated by broadly based constituents,” professional associations, or prestigious bodies in their sector.<sup>192</sup> Organizational sociologists, Paul DiMaggio and Walter Powell, have identified three factors that encourage organizations to become homogenous in behavior: (1) “‘coercive isomorphism,’ resulting from adherence to standardized procedures and structures imposed on an organization, either as a result of government regulation, affiliated group agreement, or satisfaction of a particular resource on which the organization depends”; (2) “a response to uncertainty, [causing] organizations voluntarily [to] imitate or model themselves after organizations that they perceive to be more legitimate or successful”; and (3)

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182. McAdams, *supra* note 176, at 342.

183. Posner, *supra* note 176, at 1699.

184. Eisenberg, *supra* note 177, at 1257.

185. Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2032.

186. McAdams, *supra* note 176, at 380. Norms arise and are internalized in a variety of ways. See Cooter, *Decentralized Law*, *supra* note 177, at 1661-64; Eisenberg, *supra* note 177, at 1263.

187. Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2030.

188. *Id.* at 2032-33.

189. Eisenberg, *supra* note 177, at 1260.

190. *Id.*

191. McAdams, *supra* note 176, at 376; Eisenberg, *supra* note 177, at 1258.

192. Brody, *supra* note 6, at 495.

the professionalism of managers and staff which creates pressures to conform.<sup>193</sup>

Norms pervade charitable activity. As early as the thirteenth century, papal decrees were issued to encourage individuals to donate to charitable or religious purposes.<sup>194</sup> The price for failure to follow this norm was eternal damnation.<sup>195</sup> In other words, the individual “might be denied the Eucharist and interred in unconsecrated ground.”<sup>196</sup> In Tudor times, charitable activity was part of the Puritan ethic.<sup>197</sup> The demands of the new world made philanthropy and charitable activities part of the Pilgrim code of conduct.<sup>198</sup> Alexis de Tocqueville noted the propensity of Americans of all classes to join associations—another societal norm.<sup>199</sup> In each of these periods, norms arose when there was a consensus in society as to the appropriate behavior, which typically occurred only when the behavior benefited society as a whole.<sup>200</sup> The fear of God, or of disorder, or the needs of society created tremendous pressures to conform.

Today, participation in charitable activity is an ingrained part of social life. Serving on a charitable board is a means of signaling oneself to others as a solid citizen and a responsible participant in the community. Board service brings respect. At one time that symbol was a means and an end; little more was expected, particularly if the director or trustee was a substantial contributor or the use of her

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193. *Id.* at 496 (citing Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, in *THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS* at 63, 67-73 (Walter W. Powell & Paul J. DiMaggio eds., 1991)).

194. See JONES, *supra* note 8, at 3 (citing Letter of Authorisation for Collectors for Charitable Institutions, approved by the 4th Lateran Council (1215) and included in the decretals of Gregory IX) (“A Papal Decretal of Gregory IX urged the faithful to seek their salvation by bequeathing part of their wealth to the support of pious causes.”).

195. 2 SIR FREDERICK POLLOCK & FREDERICK WILLIAM MAITLAND, *THE HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I*, at 356 (London, Cambridge 2d ed. 1898).

196. JONES, *supra* note 8, at 3.

197. Puritanism encouraged an attack on poverty by combining the discipline of Presbyterian doctrine, “relief for the impotent poor, work for the sturdy, . . . punishment for the idle” and support of philanthropic organizations for individuals to benefit and improve themselves. CHRISTOPHER HILL, *THE CENTURY OF REVOLUTION 1603-1714*, at 70-71 (2d ed. 1982). Throughout the seventeenth century, charitable endowments were created to serve the poor. See W.K. JORDAN, *PHILANTHROPY IN ENGLAND 1480-1660*, at 90 (2d ed. 1964) (discussing the private financing of poor areas in urban centers).

198. John Winthrop’s *A Model of Christian Charity* 1630, and Cotton Mather’s *Bonifacius or Essays to Do Good* were early promulgators of a charitable ethos. See ROBERT H. BREMNER, *AMERICAN PHILANTHROPY* 5-15 (Daniel J. Boorstin, ed., 2d ed. 1988).

199. 2 ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 106 (Vintage Books 1945) (1840).

200. Cooter, *Structural Adjudication*, *supra* note 178, at 224.

name gave the organization respectability. This led to a passive, often uninvolved role as a nonprofit director. Even so, there were certain fundamental norms that governed fiduciary behavior.<sup>201</sup> Fiduciaries understood implicitly that they were not supposed to steal from the charities whose assets they controlled.<sup>202</sup> Almost everyone at every time would agree that larcenous behavior deserved disapproval or censure, particularly if it might be detected.<sup>203</sup> Beyond that, the social norms governing fiduciary behavior are uncertain. One's behavior sometimes is the individual's moral compass.

The primary non-externally imposed sanction upon nonprofit trustees is shame—the embarrassment that publicity will reveal a director of a charity to be guilty of a breach of fiduciary duty. Such publicity or “shame risk” proves a more effective deterrent to opportunistic behavior than the fiduciary rules of nonprofit law. The absence of caselaw on the state level,<sup>204</sup> the norm-like generality of the statutes themselves,<sup>205</sup> and the lack of enforcement capacity by government officials at the state and federal levels,<sup>206</sup> suggest that the best and most efficient way to improve charitable accountability may be through encouragement of responsible norm-based behavior, defined as behavior that a well-functioning legal regime would encourage.

Much of the law relating to fiduciary behavior is the explication of social norms, which may explain why the statutes are so abstract in language. Though fiduciary laws have been codified for many years, their content is generally unknown by the public and charitable fiduciaries.<sup>207</sup> Most nonprofit organizations do not have in-house counsel who can advise fiduciaries on an ongoing basis, and the dearth of state caselaw provides little guidance. How are fiduciaries supposed to act when the situation is not so unambiguous regarding whether to steal

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201. Eisenberg, *supra* note 177, at 1265.

202. See Joel L. Fleishman, *Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform*, in *PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA* 172, 177-78 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999) (concluding that most intelligent people understand that nonprofits are run in an appropriate manner).

203. See McAdams, *supra* note 176, at 355 (arguing that “[i]f many people agree that a behavior deserves disapproval, if there is an inherent risk that the behavior will be detected, . . . then the pattern of disapproval itself creates costs to the behavior”).

204. This is in marked contrast to federal statutes and regulations which are arcane, complicated, and have generated substantial administrative and judicial rulemaking. See, e.g., I.R.C. § 6033 (2000) (setting forth the requirement that certain tax-exempt organizations file annual returns).

205. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1988) (creating a standard of care for nonprofit directors).

206. Vanderwarren, *supra* note 170, at 975.

207. Cf. McAdams, *supra* note 176, at 403 (indicating that without media coverage, the public does not learn of legislative activity).

or not? From where do the other social norms governing fiduciary behavior come? The law gives expression to appropriate fiduciary behavior.

### A. *Fiduciary Statutes as Expressive Law*

It is a truism that laws carry or express meanings. The expressive theory of law basically states that the law sends a message, conveying additional meanings that extend beyond the cold words of a statute.<sup>208</sup> Law contains, in Professor Lawrence Lessig's words, "social meanings"<sup>209</sup>—guides to behavior that are incentives to certain actions and stigmas to others.<sup>210</sup> The social meanings of some of the fiduciary statutes induce conduct that complies with social norms.<sup>211</sup> Thus, the fiduciary rules can be thought of as generalized social norms, rather than concrete guides to behavior.<sup>212</sup>

Social norms are interrelated with the expressive functions of law. When the law makes a statement, it can strengthen a norm embodied in a particular statute or weaken a norm it condemns.<sup>213</sup> Thus, government can impede unwanted norms—smoking and littering are two examples—or facilitate desirable norms, such as recycling. Law can influence behavior by changing and shaping the norms that determine the meaning of certain kinds of behavior, thereby enhancing compliance with the law.<sup>214</sup> Shaping social norms can be more efficient than increasing the resources spent on enforcement efforts or sanctions. When social norms encourage people to engage in appro-

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208. See Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2051 (noting that "[m]any debates over the appropriate content of law are really debates over the statement that law makes").

209. See Lessig, *supra* note 177, at 951.

210. *Id.* at 950.

211. *Id.* at 998.

212. For example, the language of the "duty of care" section of the New York Not-for-Profit Corporation Law, which occurs in the statutes of other states, is one such abstract statute. See CAL. CORP. CODE § 5231(a) (West 1990) (establishing that "[a] director shall perform the duties . . . in good faith . . . and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances"); N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (McKinney 1997) (declaring the standard of care to be "good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise").

213. Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2034-35.

214. See Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. CHI. L. REV. 607, 608 (2000) (describing the interplay between norms, laws, and decisionmakers in the enforcement of the law); Lessig, *supra* note 177, at 997-98 (discussing the incentive effect of social meanings).

priate behavior, it comes at a lower cost than the imposition of a legal sanctioning regime. Therefore, it is more efficient.<sup>215</sup>

The expressive dimension of governmental action plays a central, but unappreciated, role in a variety of areas of the law: constitutional law, criminal law, family law, and the law relating to tax-exempt organizations. Professor Cass Sunstein has argued that the main expressive role of law, insofar as it is properly expressive, is in shaping social norms.<sup>216</sup> In the nonprofit setting, where resources for enforcement are sparse, the ability to inculcate norms of appropriate behavior is particularly important. An accountability regime, which has as its primary focus remedial and educational functions, will be more cost effective than additional governmental enforcement activity which not only increases costs from the public purse, but also may increase the transaction costs of the affected organizations.<sup>217</sup>

Thus, the task of government should be to take steps through statutes, regulations, expressions of policy, and publicity to shape those norms and behavior it wants to encourage and to impede those it seeks to discourage. Ideally, law should "affect behavior by strengthening the nonlegal enforcement of the norm."<sup>218</sup> This can be done by new legislation, or as several norms scholars have noted, through increased publicity,<sup>219</sup> or, in the nonprofit sector, by the creation of bodies as suggested in this proposal. Professor Sunstein suggests that a large objective of the law is to shift social norms and social meaning.<sup>220</sup> The relevant law may signal a new norm and the enforcement of new sanctions but little in the way of enforcement activity. In these situations, the law occupies a signaling function of appropriate behavior and "inculcat[es] the expectation of social opprobrium and . . . shame in those who deviate from the announced new norm."<sup>221</sup> A good deal of governmental action is self-consciously designed to change norms, and the problem in the nonprofit situation is what ap-

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215. Posner, *Tax Compliance*, *supra* note 178, at 1791.

216. Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2025-26.

217. *See infra* note 248 and accompanying text (discussing I.R.C. § 4958—the intermediate sanctions legislation).

218. McAdams, *supra* note 176, at 399.

219. *See id.* at 403 (discussing the media's consensus building effect in changing norms); Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2050-51 (describing the role of politicians in law as a norm changing technique).

220. Sunstein, *On the Expressive Function of Law*, *supra* note 177, at 2031.

221. *Id.* at 2032. When expressive law shifts social norms and social meanings, there may "be *norm cascades*, as reputational incentives shift behavior in new directions." *Id.* at 2032-33 (citing TIMUR KURAN, PRIVATE TRUTHS, PUBLIC LIES: THE SOCIAL CONSEQUENCES OF PREFERENCE FALSIFICATION 3 (1995)).



proach or technique government should adopt to effect a normative change which will alter behavior in the direction government desires.

*B. Normative Elements of Nonprofit Fiduciary Duties of Care and Loyalty*

The fiduciary duties of care and loyalty are driven largely by social norms. The duty of care statutes prescribe liabilities for unlawful distributions,<sup>222</sup> but generally eliminate most liability if the director is uncompensated.<sup>223</sup> The actual mandates of the statutes are aspirational. The general standards for directors include that a director exercise his duties in "good faith" with the care that "an ordinarily prudent person in a like position would exercise under similar circumstances."<sup>224</sup> These standards or moralistic phrases reflect shared norms of appropriate behavior.

Until very recently, the duty of care was a minimal, passive responsibility. Professor Eisenberg has shown how the directorial duty of care in the for-profit context rose significantly in the past fifteen years, at the same time that liability for duty of care violations was cut back.<sup>225</sup> The change he describes is due to a shift in social norms to a more rigorous standard.<sup>226</sup>

The level of directorial care is largely driven by social norms rather than the threat of liability.<sup>227</sup> In the past decade, an inefficient, non-obligational norm that allowed and protected a lower duty of directorial care was replaced by a more efficient, obligational norm requiring a higher level of expected attention and informed decision making.<sup>228</sup> The shift in this norm was driven by a change in belief systems, and in the area of the duty of loyalty, by the threat of liability.<sup>229</sup> Caselaw influenced the changing norms involving the duty of

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222. N.Y. NOT-FOR-PROFIT CORP. LAW § 719(a)(1), (5) (McKinney 1997) (establishing that directors are jointly and severally liable for distributing cash or property to members and making loans to directors or officers); *see* REVISED MODEL NONPROFIT CORP. ACT § 8.33(a) (1988) (holding directors personally liable for unlawful distributions).

223. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 720-a (exempting uncompensated directors and others from liability except to the organization).

224. REVISED MODEL NONPROFIT CORP. ACT § 8.30(a)(1)-(2).

225. Eisenberg, *supra* note 177, at 1266-67. In addition to Professor Eisenberg, other authors like William Allen, Jack Jacobs, and Leo Stine have commented on the increase in duty of care cases against directors in the last fifteen years. William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1290 (2001).

226. Eisenberg, *supra* note 177, at 1268-70.

227. *Id.* at 1265.

228. *Id.* at 1268-69.

229. *Id.* at 1269.

care, clarified and elaborated on the fiduciary responsibilities,<sup>230</sup> and self-regulatory standards,<sup>231</sup> and adopted a more proactive duty of care standard.<sup>232</sup> The change in duty of care norms was contemporaneous with statutory provisions eliminating or limiting the personal liability of a director.<sup>233</sup> Professor Eisenberg attributes the shifts in caselaw to media coverage, closer scrutiny by institutional investors, and new information conveyed by takeover bids.<sup>234</sup>

In the nonprofit area, a shift in fiduciary norms is beginning to occur, but the causal agents of corporate law are not so effective. When an attorney general brings an action against a charity, the most sensible and rational response of the board is to settle the matter as soon as possible, both to save the reputation of the organization and to avoid publicity and shame to the board member.<sup>235</sup> Unlike the corporate sector, there are neither shareholders nor investment analysts to focus on the organization and there is generally less information available. In the corporate world there are copious reports, bulletins, and analyses by the financial press. Coverage of the nonprofit sector is more episodic and infrequent, though this is beginning to change.<sup>236</sup>

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230. *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (concluding that a director's duty of care encompasses the duty to make informed business decisions, and that generally, determining whether a director has violated the informed judgment duty should be based on a gross negligence analysis); *CEDE & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368-70 (Del. 1993) (stating that a breach of the duty of care will not be found unless there has been a failure to gather information prior to an important decision and rejecting the lower court's conclusion that a finding of breach also requires a monetary loss), *modified in part*, 636 A.2d 956 (Del. 1994).

231. See PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 5.02 (1994) (recommending a duty of fair dealing).

232. See *In re Caremark Int'l, Inc. Derivative Litigation*, 698 A.2d 959, 968 (Del. Ch. 1996) (asserting that the duty of care inquiry focuses on whether there was a good faith effort to be informed and exercise judgment); *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981) (stating that "[d]irectors are under a continuing obligation to keep informed about the activities of the corporation").

233. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

234. Eisenberg, *supra* note 177, at 1268-69. The difference between the takeover offer bid price and the existing stock market price communicates information about managerial inefficiency. *Id.* at 1269.

235. The duty of care violations involving Adelphi University provide an exception. See Comm. to Save Adelphi v. Diamandopoulos (Bd. of Regents Feb. 5, 1997), at <http://www.regents.nysed.gov/adelphi.html> (last visited Oct. 3, 2002) (recommending the removal of trustees for various actions). In that case, the primary opportunistic fiduciary was the president who controlled the board and was unwilling to settle. *Id.* The matter was an administrative one involving the New York State Board of Regents, which has ultimate supervisory authority over education in the state. *Id.*

236. See DeGaudenzi, *supra* note 174, at 204-05 (describing media coverage of the PTL ministry scandal and mismanagement in Health Net, the United Way, and the Cystic Fibrosis Foundation).

The duty of loyalty deals with conflict of interest situations—transactions in which fiduciaries have a direct or indirect interest.<sup>237</sup> Under the law of charitable trusts, such transactions by a trustee are prohibited.<sup>238</sup> However, nonprofit corporation law has moved to the business corporate standard, whereby the fact that a transaction is interested is less important than the process by which it is approved and its fairness to the corporation.<sup>239</sup> Thus, the statutes require, but do not explicate, a duty of loyalty. They offer road maps to obtain approval of the interested transaction and essentially deal with whom has the burden of proof when such transactions are attached.<sup>240</sup> Breaches of loyalty are often difficult to uncover, and as some interested transactions may be a necessity for the nonprofit, there is no bright line differentiating appropriate from inappropriate transactions.

Unlike the duty of care, where organizations may hold harmless directors even though there is a fiduciary violation,<sup>241</sup> duty of loyalty breaches can result in penalties. The remedies at the state level have included restitution of improperly acquired funds<sup>242</sup> and the creation of a constructive trust for the organization.<sup>243</sup> However, in a situation where the organization has not been harmed,<sup>244</sup> a court merely required the directors to read the court's opinion and to create a procedure to disclose all interested transactions.<sup>245</sup>

On the federal level, the original remedy for duty of loyalty violations was revocation of tax exemption,<sup>246</sup> a sanction so draconian and infrequently exercised, save for the most egregious situations, that it

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237. RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. c (1959).

238. *Id.* § 170(1)-(2); *see also id.* § 379 cmt. a (describing the various duties of a charitable trustee). Parts of section 379 have been revised. *Id.* § 379 (revised 1992).

239. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.31 (1988) (establishing the approval method for conflict of interest transactions).

240. *See id.*

241. *Id.* § 8.30 cmt. 2.

242. *See* John v. John, 450 N.W.2d 795, 797-98, 806 (Wis. Ct. App. 1989) (affirming the discussion of the lower court that removed the director from all posts and ordered restitution of \$1.7 million).

243. *See* Mile-O-Mo Fishing Club, Inc. v. Noble, 210 N.E.2d 12, 16 (Ill. App. Ct. 1965) (reversing the lower court's decision and requiring that the former president hold a certain piece of property until the president's former organization could pay for the land).

244. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries, 381 F. Supp. 1003, 1016 (D.D.C. 1974) (noting instances of self-dealing that resulted in insignificant harm).

245. *Id.* at 1020-21.

246. Revised Proc. 90-27, 1990-1 C.B. 514.

had little deterrent effect.<sup>247</sup> In 1996, Congress created a new regulatory scheme with sanctions short of an exemption revocation when sections 501(c)(3) or 501(c)(4) organizations provide excessive economic benefits to insiders.<sup>248</sup>

Norms do exist that seek to freshen the atmosphere when interested transactions are considered. Perhaps surprisingly, they are not included in the statutes. State legislation typically requires disclosure of material facts or the fiduciary's interest in the transaction.<sup>249</sup> For example, most jurisdictions do not require the interested party to absent herself from the deliberations concerning the interested transaction.<sup>250</sup> The interested director usually can be considered for quorum purposes,<sup>251</sup> and if necessary can cast a vote in favor of the transaction.<sup>252</sup> Well-run nonprofits should have a conflict of interest policy, which is not required by statute in any jurisdiction save one.<sup>253</sup> Some nonprofit professional organizations recommend such policies,<sup>254</sup> but many organizations, even of substantial size, have no such procedures.<sup>255</sup> Other private normative standards suggest that interested directors take no part in the deliberations concerning the particular transactions.<sup>256</sup>

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247. See DeGaudenzi, *supra* note 174, at 214 (asserting that the remedy is harsh and may not punish the wrongdoer).

248. I.R.C. § 4958 (2000). The enforcement regime is based on the approval previously used for private foundations. I.R.C. §§ 4941-4945. Under the new approach, if an insider receives an "excess benefit transaction," a penalty, an excise tax of 25 percent of the excess benefit is imposed upon the person engaged in the excess benefit transaction. *Id.* § 4958(a)(1). Lesser penalties can be imposed on the organization's managers who knowingly permit the organization to engage in the excess benefit transaction. *Id.* § 4958(a)(2). The excise tax increases to 200 percent if there is a repeat violation. *Id.* § 4958(b). Loss of exemption could still occur in egregious situations. Treas. Reg. § 53.4958-8 (2002).

249. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1997).

250. See, e.g., *id.* § 715(a).

251. See, e.g., *id.* § 715(c).

252. See, e.g., *id.* § 715(a)-(b).

253. Arizona requires nonprofit corporations that have assets with a book value of more than \$10 million or revenues greater than \$2 million to adopt a conflict of interest policy regarding transactions between the corporation and "interested persons." ARIZ. REV. STAT. ANN. § 10-3864 (West Supp. 2001). "Interested person" refers to an officer or director of the nonprofit but not an employee. *Id.*

254. See COUNCIL OF BETTER BUS. BUREAUS, INC., *supra* note 181 (stating that "[t]he governing board has the ultimate oversight authority for any charitable organization . . . . To meet these standards, the organization shall have . . . [n]o transaction(s) in which any board or staff members have material conflicting interests with the charity resulting from any relationship or business affiliation.").

255. See Carvajal, *supra* note 128 (discussing a case in which the Alvin Ailey Dance Company had no conflict of interest policy when it awarded an architectural commission to the chair of the board's son-in-law without any competition).

256. See Debbie Mack, *Circuit Roundup*, CORP. LEGAL TIMES, Sept. 2002, at 60 (reporting on an appeals court's affirmance of decision that found directors had not engaged in self-

C. *Intermediate Sanctions: Changing Nonprofit Norms*

At the federal level social norms have played an important role in defining and fleshing out ambiguous federal fiduciary standards. The fundamental rule against opportunistic fiduciary behavior is the prohibition against private inurement.<sup>257</sup> In order to obtain exemption under section 501(c)(3) of the Internal Revenue Code, no net earnings may inure to insiders such as founders, directors, or officers.<sup>258</sup> The private inurement prohibition is “the primary distinction between taxable and tax-exempt entities.”<sup>259</sup> This rule though first adopted in 1909<sup>260</sup> remains elusive, elastic, vague, and inconsistently applied.<sup>261</sup>

It had always been recognized to be wrong for nonprofit executives to pay themselves excessive compensation or engage in other opportunistic behavior. Beyond the vague inurement proscription, federal law only dealt specifically with fiduciary behavior for private foundations,<sup>262</sup> where Congress believed there had been abuses by donors and insiders. State principles against excessive compensation were seen as soft-core interested transactions and were less venal than other forms of interested transactions.<sup>263</sup> Congressional hearings in 1993 produced several outrageous instances of excessive compensation.<sup>264</sup> Though the existing federal law could penalize the organization by removing recognition of its tax-exempt status, the Internal

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dealing because they informed other directors of these conflicts and abstained from the decision at issue).

257. I.R.C. § 501(c)(3) (2000).

258. *Id.* A related “private benefit” doctrine prohibits section 501(c)(3) organizations from providing a substantial economic benefit to “private interests.” See Treas. Reg. § 1.501(c)(3)-1(d)(ii) (2002). As interpreted by the I.R.S., a “private benefit” must be more than incidental to disqualify an organization in contrast to the absolute ban on private inurement. *Id.* § 1.501(c)(3)-1(c)(1).

259. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 577 (2000).

260. Corporation Special Excise Tax of 1909, Pub. L. No. 61-5, 36 Stat. 11, 112.

261. Jones, *supra* note 259, at 590 (stating that “the courts and the [Internal Revenue] Service are content to proceed as though private inurement is incapable of definition, but as easily recognizable, as pornography. The result is a chameleon-like doctrine that seemingly defies precise identification or prediction.”). The absence of guidance, the generality of the phrase, and the infrequency of the use of the sanction—revocation of tax-exempt status—became a practical problem. The generality and ambiguity of the rule was insufficient to signal normative behavior.

262. See I.R.C. §§ 4941-4945.

263. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW § 715(e) (McKinney 1997) (giving authority to fix board compensation without any of the procedures applying to other interested transactions).

264. See SUBCOMM. ON OVERSIGHT OF HOUSE COMM. ON WAYS AND MEANS, 103D CONG., REPORT ON REFORMS TO IMPROVE THE TAX RULES GOVERNING PUBLIC CHARITIES 14-15 (1994).

Revenue Service rarely, if ever, imposed such a penalty,<sup>265</sup> because the removal of exemption was like hanging someone for stealing a loaf of bread. It was too draconian for the wrong, and hurt the organization rather than the individuals who engaged in private inurement. Thus, Congress passed Internal Revenue Code section 4958,<sup>266</sup> the so-called intermediate sanctions legislation.<sup>267</sup>

The legislation itself did not say what was excessive compensation,<sup>268</sup> but did express the norm and thereby, strengthened it.<sup>269</sup> It created the concept of an “excess benefit transaction,” and placed a tax upon individuals, insiders who “exercise substantial influence” on nonprofit organizations.<sup>270</sup> The regulations suggest a procedure whereby the organization can rely on a rebuttable presumption that the transaction is not an excess benefit transaction if: (1) its terms were approved by a board or board committee composed of individuals who have no conflict of interest; (2) disinterested board members relied upon comparable data; and (3) the board “adequately documented the basis for its determination.”<sup>271</sup>

The regulation creates guidelines for new behavioral norms: (1) people who are interested in a transaction should not participate in the decision; (2) comparability requires people to look around to see if the transaction is fair; and (3) adequate documentation is required.<sup>272</sup> This procedure results in a more rational, formalized approach guided by experts, such as lawyers and compensation consultants. These norms further reinforce the state fiduciary standards and flesh them out. Though the IRS’s audit capability has declined,<sup>273</sup> its reputation and the fear the Service engenders may improve fiduciary behavior. The intermediate legislation strength-

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265. Kevin F. Donohue, *Crossroads in Hospital Conversions—A Survey of Nonprofit Hospital Conversion Litigation*, 8 ANNALS HEALTH L. 39, 91 (1999); see also Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals’ Changes in Charitable Status*, 23 AM. J.L. & MED. 221, 223 n.13 (1997).

266. I.R.C. § 4958.

267. See Gary, *supra* note 14, at 633 (citing Grant Williams, *Stopping Excessive Benefits*, CHRON. PHILANTHROPY, Aug. 13, 1998, at 29).

268. See *id.*

269. See McAdams, *supra* note 176, at 397 (stating that “law can strengthen a norm by imposing sanctions on those who violate it”).

270. I.R.C. § 4958; see also Gary, *supra* note 14, at 632-33; Shannon McGhee Hernandez, Note, *Conversions of Nonprofit Hospitals to For-Profit Status: The Tennessee Experience*, 28 U. MEM. L. REV. 1077, 1092-93 (1998).

271. Treas. Reg. § 53.4958-6T(a) (2002).

272. See *id.*

273. GAO REPORT, *supra* note 6, at 3 (noting “[f]rom 1996 through 2001, IRS staffing for overseeing exempt organizations fell by about 15 percent while the number of . . . Forms 990 filed by charities increased 25 percent [and] [t]he rate at which the IRS ex-

ened the nonprofit community's adherence to a norm, and gave expanded publicity by placing the norm in the tax laws and regulations. As this norm becomes publicized, more charitable fiduciaries will internalize it, thereby reinforcing it and raising fiduciary standards as a whole.<sup>274</sup>

However, this new norm comes at a substantial cost for nonprofit organizations. Larger organizations as a matter of course retain expensive compensation consultants. The regulations allow smaller organizations to obtain salary comparisons with these similar sized nonprofits to gain use of the non-excess benefit presumption.<sup>275</sup> The revenue generated by the excise tax imposed for violations of the statute probably will be nowhere near the transaction costs to nonprofit organizations.

A statute can strengthen a norm by imposing sanctions on those who violate it. The enforcement effort by the Internal Revenue Service will not increase, but most organizations will adhere to the newly defined norm. Not so obvious as an enforcement action or monetary sanction, the law can enhance a norm—in this case the proscription against private inurement—by “expressing it” through regulations without taking extra enforcement actions.<sup>276</sup> However, this change in normative behavior, though effective is inefficient because of the costs to those affected by it. A more efficient approach to changing normative behavior and improving fiduciary obligations is proposed in Part VI of this Article.

#### IV. PROBLEMS OF ENSURING CHARITABLE ACCOUNTABILITY

Accountability is the requirement that charitable organizations have to report their activities, explain their mission, and justify their finances.<sup>277</sup> Charities are accountable to the public and exist because

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amined these returns” fell to .43 percent in 2001 compared to .73 percent in 1998 and 1999).

274. Cf. McAdams, *supra* note 176, at 379-80 (arguing that internalization does not explain all norms, specifically non-unanimous consent norms because a unanimous consensus could not have existed before the norm existed and “internalization of norms . . . sometimes provides the only explanation for behavior”).

275. Treas. Reg. § 53.4958-6T(c)(2)(ii).

276. McAdams, *supra* note 176, at 397-98.

277. See Kevin P. Kearns, *The Strategic Management of Accountability in Nonprofit Organizations: An Analytic Framework*, 54 PUB. ADMIN. REV. 185, 186 (1994) (accountability involves concepts of “oversight agenc[ies] with explicit standards of performance . . . and formal record keeping and reporting requirements as a means of demonstrating compliance with standards”).

they provide a public benefit to society.<sup>278</sup> There are several kinds of accountability. One is financial. Financial accountability inquires into whether the assets of the corporation are being used properly and whether the financial information is being disclosed adequately and accurately.<sup>279</sup> The complex reporting requirements relating to charitable fundraising is another kind of financial accountability. A third type of accountability requiring a more qualitative type of analysis inquires whether charities are attaining their missions.<sup>280</sup> A fourth type of accountability concerns whether the officers, directors, and trustees have lived up to their responsibilities or have used the organization to benefit themselves.<sup>281</sup> This has been called “negative accountability.”<sup>282</sup> Another critical accountability issue considers who should be able to hold the charity accountable.<sup>283</sup>

#### A. *Who Can Hold Charities Accountable: Standing Issues*

A fundamental distinction between the business corporation, where shareholders have formal legal authority to assume fiduciary accountability, and the nonprofit organization is the limited nature of

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278. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983) (stating that “[c]haritable exemptions are justified on the basis that the exempt entity confers a public benefit”).

279. The IRS Form 990 Annual Report, the fundamental reporting tool, has been criticized. See ELIZABETH K. KEATING & PETER FRUMKIN, REENGINEERING NONPROFIT FINANCIAL ACCOUNTABILITY: TOWARD A MORE RELIABLE FOUNDATION FOR REGULATION 10-12 (The Hauser Ctr. for Nonprofit Orgs. & Kennedy Sch. of Gov’t, Harvard Univ., Working Paper No. 4, 2000) (analyzing the Form 990); Swords, *supra* note 170, at 598-605 (examining the portions of the Form 990 that deal with aggregate payments and concluding that they will most likely not contain information regarding self-dealing transactions); GAO REPORT, *supra* note 6, at 8-13 (declaring that the accuracy of the information on 990 is unknown).

280. Vanderwarren, *supra* note 170, at 963-64.

281. See I.R.C. § 501(c)(3) (2000) (earnings of nonprofits cannot go to private individuals); REVISED MODEL NONPROFIT CORP. ACT § 8.31 (1988) (indicating when a conflict of interest is acceptable).

282. See Swords, *supra* note 170, at 598 (indicating that the aggregate payment portions of the Form 990 do not deal well with “negative accountability,” i.e. self-dealing problems).

283. See REVISED MODEL NONPROFIT CORP. ACT xxvi-xxvii (indicating that attorneys general have the responsibility of monitoring nonprofit corporations). There are many ways to analyze the components of nonprofit accountability. Professor Kevin Kearns has categorized four types of nonprofit accountability: (1) “compliance accountability,” which requires adherence to legal and contractual obligations; (2) “negotiated accountability,” which is a “negotiation” between the nonprofit and its environment as the charity deals with loosely defined social values and political trends; (3) “professional/discretionary accountability,” which reflects the industry-wide performance standard of professionals working for the organization; and (4) “anticipatory/positioning accountability,” which acknowledges that the organization can anticipate future compliance standards and could “attempt to play a meaningful proactive role in shaping and defining the standards” by lobbying for certain policies and practices. Kearns, *supra* note 277, at 188-89.



standing to sue by the many classes affected by the nonprofit enterprise.<sup>284</sup> Because of these traditional limitations on standing, nonprofit fiduciary duties in most situations are “legal obligation[s] without legal sanction[s].”<sup>285</sup>

1. *Members.*—If the organization is a membership organization, that is, one legally constituted to give members the right to elect directors,<sup>286</sup> a member<sup>287</sup> may have standing to sue.<sup>288</sup> Some courts have held that members of nonprofit organizations may bring derivative suits, viewing the members as analogous to shareholders in business corporations.<sup>289</sup> Members also may sue to enjoin an *ultra vires* act,<sup>290</sup>

284. Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 145 (1993) (citing DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS § 2:04 (1987 & Supp. 1992)).

285. Brody, *supra* note 6, at 466-67.

286. See CAL. CORP. CODE § 5056 (West 1990) (defining member as someone who has the right to vote for directors or on other major issues); *Hunt v. Wash. State Apple Adver. Comm'n*, 432 U.S. 333, 342 (1977) (noting that the party was not a normal membership organization because it lacked members).

287. “Member” refers to one “having membership rights in a corporation in accordance with the provisions of its certificate of incorporation or bylaws.” N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(9) (McKinney 1997). This differs from the common usage of the word “member” by nonprofit organizations, which often refers to preferred customer or patron status. See *Chamber of Commerce v. Fed. Election Comm'n*, 69 F.3d 600, 602 (D.C. Cir. 1995) (stating that the American Medical Association objects to a definition of member articulated by the Federal Election Commission that would have prohibited physicians or medical students who did not belong to state medical associations from being included as members), *clarified by* 76 F.3d 1234 (D.C. Cir. 1996).

288. REVISED MODEL NONPROFIT CORP. ACT § 6.30(a) (establishing that a “member or members having five percent or more of the voting power or by fifty members, whichever is less” may file a derivative suit); see also CAL. CORP. CODE §§ 5420(b), 7710; N.Y. NOT-FOR-PROFIT CORP. LAW §§ 623(a), 720(b)(3); Hansmann, *supra* note 5, at 606 (indicating that while most statutes are silent on standing questions, they generally adopt charitable trust rules). Some state courts have given standing to members. See *Morgan v. Robertson*, 609 S.W.2d 662, 664 (Ark. Ct. App. 1980) (stating that the law requires a member bringing a derivative suit to be a member at the instance of the contested transaction); *Brenner v. Powers*, 584 N.E.2d 569, 575 (Ind. Ct. App. 1992); *Jackson v. Stuhlfire*, 547 N.E.2d 1146, 1147-48 (Mass. App. Ct. 1990); *Leeds v. Harrison*, 72 A.2d 371, 377 (N.J. Super. Ct. Ch. Div. 1950); *Bourne v. Williams*, 633 S.W.2d 469, 471-73 (Tenn. Ct. App. 1981); *Governing Bd. v. Pannill*, 561 S.W.2d 517, 524 (Tex. Civ. App. 1977). Other courts have refused to grant members standing to sue. See *Basich v. Bd. of Pensions*, 493 N.W.2d 293, 296 (Minn. Ct. App. 1992) (affirming the trial court’s decision that congregationalists of church were not members with standing to sue); *Voelker v. St. Louis Mercantile Library Ass’n*, 359 S.W.2d 689, 698 (Mo. 1962).

289. See, e.g., *Bourne*, 633 S.W.2d at 471-73. The Revised Nonprofit Corporation Model Act provides for derivative suits by members having five percent or more of the vote or fifty in number, whichever is less. REVISED MODEL NONPROFIT CORP. ACT § 6.30 (1988). Several jurisdictions permit member derivative suits. See MICH. COMP. LAWS ANN. § 450.2491 (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a).

290. REVISED MODEL NONPROFIT CORP. ACT § 3.04.

or sue former directors or officers of a charity.<sup>291</sup> For example, members of a nonprofit luncheon club had standing to sue the organization over its refusal to admit women as members and guests in violation of the charter.<sup>292</sup> Members have been given the statutory right to inspect the nonprofit organization's records and may sue to enforce that right.<sup>293</sup> However, for nonprofit *non-membership* organizations that have self-perpetuating boards,<sup>294</sup> normally only the attorney general or a director has standing to sue.<sup>295</sup>

Under trust and corporate principles, the public lacks standing to sue absent specific statutory permission. Although the property is devoted to purposes which benefit the whole community, the benefit to an individual member of the public is incidental. Even a specific beneficiary of a charity is but an intermediary through whom the public advantage is achieved. Therefore, it is the attorney general who represents the public interest, who has the right to sue. A more practical reason for denying the public standing is that the persons benefited by charities are usually members of a large and shifting class of the public. If every member of that class had standing, the charity could be subjected to unnecessary litigation.<sup>296</sup>

Traditional standing limitations occasionally have been relaxed in matters of public importance that relate to charities or where the plaintiffs have a special interest.<sup>297</sup> A general survey of courts' willingness to allow private parties to sue for the enforcement of charitable obligations found the following elements to be of importance: (1) "the extraordinary nature of the acts complained of and the remedy sought by the plaintiff;" (2) "the presence of fraud or misconduct on the part of the charity or its directors;" (3) "the state attorney gen-

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291. *Weimer v. Amen*, 870 F.2d 1400, 1401 (8th Cir. 1989).

292. *Cross v. Midtown Club, Inc.*, 365 A.2d 1227, 1228-30 (Conn. Super. Ct. 1976).

293. *See Stueve v. N. Lights, Inc.*, 797 P.2d 130 (Idaho 1990) (granting member of nonprofit rural electric cooperative access to cooperative records); *Bourgeois v. Landrum*, 396 So. 2d 1275 (La. 1981) (granting voting church members examination rights of corporate records pursuant to Louisiana nonprofit statute).

294. James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 669-70 (1985).

295. REVISED MODEL NONPROFIT CORP. ACT §§ 1.70, 6.30.

296. Fishman, *supra* note 294, at 670.

297. *See, e.g., YMCA v. Covington*, 484 A.2d 589, 592 (D.C. 1984) (concluding that members of the YMCA had standing to sue the YMCA for breach of duty). *But see Simon v. E. Ky. Welfare Rights Org.*, 426 U.S. 26, 28 (1976) (holding that indigents did not have standing to sue the Secretary of the Treasury and Internal Revenue Service over a ruling exempting a nonprofit hospital from taxation even though it did not provide free or below-cost services to the poor); *Christiansen v. Nat'l Sav. & Trust Co.*, 683 F.2d 520, 529 (D.C. Cir. 1982) (holding that subscribers of health plan did not have standing to enforce the director's fiduciary duties).

eral's availability or effectiveness;" (4) the "nature of the benefited class and its relationship to the charity;" and (5) the "subjective and case-specific factual circumstances."<sup>298</sup> The general rule, however, remains that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit trust, or a nonprofit corporation. Nor does a member of the public have standing to sue.

2. *The Attorney General.*—The attorney general usually has the responsibility of supervision and oversight of charitable trusts and corporations, and may maintain such actions as appropriate to protect the public interest.<sup>299</sup> In a few jurisdictions, this role is performed by the district or county attorney.<sup>300</sup> Even before the enactment of the Statute of Charitable Uses in 1601, suits were brought by the attorney general to enforce charitable trusts.<sup>301</sup> Unlike a private trust, the beneficial interest in a charitable trust does not reside in individual beneficiaries but in the community, an indefinite class. The property is devoted to the accomplishment of purposes beneficial to the community at large. By definition, the objective of the public benefit corporation is to further the public interest. The attorney general represents the public in enforcing the purposes of the trust or corporation. The common law duties of the attorney general reflected the expectations of society: there should be a single evolving duty to carry out the charitable purposes of the trust,<sup>302</sup> that the trust property should be kept productive, and trustees should be prohibited from diverting charitable funds for improper purposes or self-dealing.<sup>303</sup> The common law principles asserted by the attorney general were carried over to America during the Colonial period.<sup>304</sup> These precepts have been supplemented by statute in most jurisdictions.

Today, the attorney general represents the state and the public, promoting accountability by charities and fiduciaries. The attorney

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298. Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 61 (1993).

299. CAL. CORP. CODE §§ 5142(a)(5), 5250, 6511 (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW § 112 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT §§ 1.70, 3.04(b)-(c), 8.10(a), 14.03-04.

300. See *Warren v. Bd. of Regents*, 527 S.E.2d 563, 564 (Ga. 2000); *Collins v. Citizens & S. Trust Co.*, 373 S.E.2d 612, 613 (Ga. 1988).

301. SCOTT & FRATCHER, *supra* note 24, § 391.

302. Eric S. Tower, *Directors' Duty to Obtain a Fair Price in the Conversion of Nonprofit Hospitals*, 6 ANNALS HEALTH L. 157, 171 (1997).

303. Marion Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, in THE FUTURE OF THE NONPROFIT SECTOR 75, 76 (1989); *Hunter v. St. Vincent Med. Ctr. (In re Parkview Hosp.)*, 211 B.R. 619, 636 (Bankr. N.D. Ohio 1997).

304. See generally Office of the Ohio Attorney Gen., *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, in V RESEARCH PAPERS 2705, 2710 (1977).

general has an enforcement or supervisory interest in property or income devoted to charitable uses, estates or trusts in which there is a charitable interest;<sup>305</sup> may maintain registries of charitable trusts and trustees;<sup>306</sup> and is an interested party in all proceedings affecting charitable trusts, uses, and estates.<sup>307</sup> The attorney general can institute proceedings in situations involving the state or public interest and can secure compliance with statutory norms or ensure proper administration of trusts.<sup>308</sup> The attorney general's jurisdiction extends to suits to protect charities where an attack is made on the organization's property<sup>309</sup> or to protect against self-dealing, waste, and diversion of funds.<sup>310</sup>

a. *Specific Powers of the Attorney General.*—The attorney general has the power to investigate, subpoena witnesses, and require production of books and records.<sup>311</sup> In civil actions he can annul the corporate existence, dissolve corporations that have acted *ultra vires*, or restrain them from carrying out unauthorized activities.<sup>312</sup> He may remove directors or trustees;<sup>313</sup> dissolve corporations under applicable state procedures;<sup>314</sup> enforce the rights of members, directors or officers;<sup>315</sup> bring proceedings and accounts for the assets of corporations upon dissolution;<sup>316</sup> supervise indemnification awards;<sup>317</sup> and investigate transactions and relationships of directors and trustees to determine whether property held or used by them has been allocated to charitable purposes.<sup>318</sup> The attorney general may maintain an action against a plaintiff seeking a declaratory judgment; can bring a *quo warranto* proceeding to assure that absolute gifts to charitable corpora-

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305. See, e.g., CAL. CORP. CODE §§ 5142(a)(5), 5250 (West 1990).

306. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(c) (McKinney 2002).

307. *Brown v. Mem'l Nat'l Home Found.*, 329 P.2d 118, 132 (Cal. Ct. App. 1958).

308. N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(m).

309. See CAL. CORP. CODE § 5142 (requiring that the attorney general be given notice and can intervene).

310. See N.Y. NOT-FOR-PROFIT CORP. LAW § 720(a)-(b) (McKinney 1997) (explaining actions that can be taken against directors or officers of a nonprofit corporation on behalf of the corporation).

311. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(h)(i).

312. See, e.g., CONN. GEN. STAT. § 33-1038 (1997).

313. L. Edward Bryant, Jr., *Responsibilities of Directors of Not-for-Profit Corporations Faced with Sharing Control with Other Nonprofit Organizations in Health Industry Affiliations: A Commentary on Legal and Practical Realities*, 7 ANNALS HEALTH L. 139, 154 (1998).

314. David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J.L. & MED. 327, 346 (1990).

315. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW § 720.

316. *Ebon Found., Inc. v. Oatman*, 498 S.E.2d 728, 730 (Ga. 1998).

317. *Champ v. Poelker*, 755 S.W.2d 383, 387 (Mo. Ct. App. 1988).

318. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(h)(i) (McKinney 2002).

tions are applied according to the terms of gift;<sup>319</sup> must receive notice when suit is instituted by others;<sup>320</sup> and is a necessary party to settlement of litigation where charitable beneficiaries are affected, where there is a sale of assets, or a change of use of assets is considered.<sup>321</sup> While the attorney general must receive notice of cases concerning a charity, there is no need to make him a party.<sup>322</sup> The option to intervene lies with the attorney general.<sup>323</sup>

*b. Information Gathering Responsibilities.*—In many jurisdictions the attorney general has been given statutory authority for gathering information about charities and trustees. Charitable trusts and nonprofit corporations must register and file reports with his office.<sup>324</sup> The Uniform Supervision of Trustees for Charitable Purposes Act promulgated by the National Conference on Uniform State Laws in 1954,<sup>325</sup> has been adopted in whole or part in many jurisdictions. This statute requires registration of charitable trusts and charitable corporations with the attorney general, as well as periodic reporting to the attorney general who may institute appropriate proceedings, investigate, supervise, and subpoena.<sup>326</sup> While religious corporations and certain other charities may be excluded from filing requirements, the attorney general can subpoena religious groups suspected of fraudulent behavior.<sup>327</sup> Other responsibilities of the attorney general typically include maintenance of a registry of all public benefit organizations, oversight of periodic filing requirements, and monitoring of financial filing requirements.<sup>328</sup>

*c. Oversight of Charitable Solicitation.*—In most jurisdictions the attorney general is responsible for the oversight and enforcement of regulations dealing with charitable solicitation.<sup>329</sup> This has become a major area of attorney general focus. Statutes have conferred upon the attorney general broad authority to protect the public and donors from deceptive and fraudulent solicitation practices or diversion or

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319. *St. Joseph's Hosp. v. Bennett*, 22 N.E.2d 305, 306-07 (N.Y. 1939).

320. REVISED MODEL NONPROFIT CORP. ACT § 1.70 (1988).

321. MASS. GEN. LAWS ch. 180, § 8A (1998); MINN. STAT. § 501B.41 Subd. 4 (West 2002).

322. *In re Estate of Yablick*, 526 A.2d 1134, 1136 (N.J. Super. Ct. App. Div. 1987).

323. *Bertram v. Berger*, 274 N.E.2d 667, 670 (Ill. App. Ct. 1971).

324. See ALA. CODE § 13A-9-71 (1994); N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(c) (McKinney 2002).

325. 7C U.L.A. 372 (2000).

326. 7C U.L.A. 380-83.

327. *Abrams v. Temple of the Lost Sheep, Inc.*, 562 N.Y.2d 322, 324 (N.Y. Sup. Ct. 1990).

328. See CAL. GOV. CODE § 12584 (West 1992); N.H. REV. STAT. ANN. § 7:19 (2001).

329. See N.H. REV. STAT. ANN. § 7:19; OHIO REV. CODE ANN. § 109.24 (Anderson 2001).

waste of donated funds so as to ensure the proper use of contributed funds for the beneficiaries' benefit.<sup>330</sup> Typically this includes monitoring and maintaining enforcement powers over registration requirements for charities and professional fundraisers.<sup>331</sup>

*d. Limitations on Attorney General Authority.*—Despite the authority to supervise charities, the attorney general does not have the power to manage charities in their everyday affairs.<sup>332</sup> Thus, courts have prohibited the attorney general from intervening in suits contesting wills involving charities,<sup>333</sup> from ordering deviations from trust provisions,<sup>334</sup> or from enforcing obligations owing to charities.<sup>335</sup>

*e. Standing for Others.*—Other than the attorney general, only persons with a special and definite interest, such as directors, have standing to institute a legal action;<sup>336</sup> the general public lacks such interest.<sup>337</sup> If any member of the public could initiate suit, a director or trustee would frequently be subjected to unreasonable and vexatious litigation.<sup>338</sup>

*f. Obstacles to Enforcement.*—Staffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent. Only thirteen states have charities sections within attorneys general offices.<sup>339</sup> These states are home

330. CAL. BUS. & PROF. CODE § 17510.3 (West 1997) (requiring affirmative disclosures by donation solicitors).

331. *See id.*

332. *Estate of Horton v. Bradley*, 90 Cal. Rptr. 66, 68 (Cal. Ct. App. 1970) (finding that the attorney general could not meddle in a charity's contractual agreements).

333. *See Estate of Roberts v. First Nat'l Bank*, 373 P.2d 165, 174 (Kan. 1962); *Kentucky ex rel. Ferguson v. Gardner*, 327 S.W.2d 947, 949 (Ky. 1959).

334. *Midkiff v. Kobayashi*, 507 P.2d 724, 745 (Haw. 1973).

335. *Lefkowitz v. Lebensfeld*, 415 N.E.2d 919, 922 (N.Y. 1980).

336. Alison Manolovici Cody, *Success in New Jersey: Using the Charitable Trust Doctrine to Preserve Women's Reproductive Services When Hospitals Become Catholic*, 57 N.Y.U. ANN. SURV. AM. L. 323, 347-48 (2000).

337. *Arizonians for Official English v. Arizona*, 520 U.S. 43, 64 (1997).

338. *See* BOGERT & BOGERT, *supra* note 19, § 411; *see also* Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 659 (1998) (explaining that an expansion of standing may result in a variety of claims not necessarily involving fiduciary duties of charities as charities). For an interesting article suggesting that certain environmental organizations be granted statutory standing, *see* Karl S. Coplan, *Direct Environmental Standing for Chartered Conservation Corporations*, 12 DUKE ENVTL. L. & POL'Y F. 183, 184 (2001).

339. PETER SWORDS & HARRIET BOGRAD, *NONPROFIT ACCOUNTABILITY: REPORT AND RECOMMENDATIONS* (Nonprofit Coordinating Comm. of N.Y., Inc. 1997), <http://www.charitychannel.com/forums/cyb-acc/resources/accrept.html> (last visited Oct. 22, 2002).

to fifty-five percent of United States charities and have sixty-five percent of national charitable revenues.<sup>340</sup> Except for New Hampshire and New Jersey, each of the thirteen states has at least three full-time attorneys.<sup>341</sup> Some states have incorporated multi-accountability functions within their attorney general's office. This includes: registration and reporting systems for organizations and for professional fundraiser solicitors, enforcement programs used to protect charitable assets and deter fundraising abuse, educational programs that encourage responsible board governance and awareness of fundraising fraud, and "oversight of charitable trusts or bequests."<sup>342</sup> Some offices also oversee structural changes such as mergers. Many of these integrated offices budgets' are self-sustaining through administrative fees. A second frequent organizational pattern is that enforcement functions are divided from the registrational and reporting responsibilities. The attorney general handles enforcement, and another state body—the secretary of state, the consumer protection agency, or some other office—specifically deals with registration and licensing.<sup>343</sup> The Swords-Bogard survey found that ten states have "no general system of registration and reporting for charities."<sup>344</sup>

g. *Inaccurate or Incomplete Data.*—Information gathering responsibilities and statutory oversight of charitable solicitation do not by themselves make the attorney general an active or efficient monitor of nonprofit organizations or improve charitable accountability. Most of the information filed is never reviewed by anyone.<sup>345</sup> The data submitted by the nonprofit can be manipulated. For example, Part II of Form 990, the annual federal information return, requires a listing of fundraising expenses. Studies by the *Chronicle of Philanthropy* and the Urban Institute's Center on Nonprofits and Philanthropy have found that a substantial percentage of charities surveyed reported on their Form 990's that they incurred no fundraising costs, while comparable state filing records revealed that in fact the charity spent substantial amounts on fundraising.<sup>346</sup> The General Accounting Office con-

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340. *Id.*

341. *Id.*

342. *Id.*

343. *Id.*

344. *Id.* (stating "Texas still has an actively staffed charities office within the state attorney general's office, and Iowa has an active program of prosecution of solicitation fraud").

345. *See id.* (noting that state regulators have limited resources and few problems are identified from reporting forms).

346. The *Chronicle* found that for the 1996 tax year "more than one-fourth of the 4,889 nonprofit organizations that received \$500,000 or more in gifts from private sources reported spending *nothing* on fund raising." Holly Hall et al., *Charities' Zero-Sum Filing Game*,

cluded from an analysis of Form 990 data from 1994-1998 that, on average, sixty-four percent of charities claimed no fundraising expenses.<sup>347</sup>

There are substantial incentives for charities to minimize fundraising expenses. Charities will seem more efficient if they can show that they devote a greater percentage of spending to program services and a lesser percentage to general management and fundraising expenses.<sup>348</sup> It avoids discouraging potential donors who might rely on attorneys general or other organizations that suggest charities with fundraising costs over a certain percentage are wasteful. Because charities have discretion to allocate expenses, and there is overlap among the types of expenses, charities systematically minimize those costs that might make them seem less efficient.<sup>349</sup> Many organizations justifiably believe that their fundraising efforts are educational in nature and allocate a percentage of costs to education.<sup>350</sup> However, there is concern that charities systematically underreport fundraising expenses by "netting" such expenses against the total funds raised.<sup>351</sup> Often charities will dump fundraising costs into "other expenses."<sup>352</sup>

*h. Limitations on Sharing Information.*—Form 990 has become a major disclosure tool at the state level as the result of cooperation between the IRS, the National Association of State Charity Officials and the National Association of Attorneys General. The Form 990 is

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CHRON. OF PHILANTHROPY, May 18, 2000, at 1 (emphasis added). The Urban Institute study examined computerized returns from the 1997 and 1998 tax years and found that "thirty-five percent of charities that received \$500,000 to \$1 million from private sources reported that they spent nothing on fundraising," as did thirty percent of those who raised between \$1-5 million and nearly twenty-five percent who garnered more than \$5 million. *Id.*

347. GAO REPORT, *supra* note 6, at 12. The report also criticized the IRS for its failure to ensure the accuracy of expense data. *Id.* at 9-10.

348. *Id.* at 8-9. Analysis of Form 990 data from 1994-1998 showed that charities typically apportioned 87 percent of their spending to charitable program services, 12 percent to general management expenses, and only 1 percent to fundraising costs. *Id.* Program services include providing goods and services to beneficiaries or members to fulfill the organization's charitable purposes. *Id.* at 8 n.7. Fundraising activities encompass attracting donations. *Id.* General management expenses include "salaries, travel, professional fees, and other expenses." *Id.*

349. *Id.* at 8-9, 15-16.

350. *See id.* at 15.

351. *Id.* at 9-10. An example of netting occurs when a charity contracts with a professional fundraiser to garner donations. "The fundraiser might raise \$250,000, charge the charity \$150,000, and give the charity the remaining \$100,000. When reporting to the IRS, the charity 'nets the fundraising expenses' by reporting \$100,000 as a direct public contribution and does not report the \$150,000 retained by the professional fundraiser . . .," a violation of filing instructions. *Id.*

352. *Id.* at 10.



acceptable to most state officials for purposes of filing an annual report in the majority of states requiring such a filing.<sup>353</sup> However, there are substantial limitations on the ability of state and federal officials to cooperate and share information. The IRS does not proactively share information with state officials on revocations or denials of tax-exempt status.<sup>354</sup> Federal law protecting taxpayer privacy generally prohibits the IRS from sharing data concerning charities.<sup>355</sup> Even for data that the Service can share with the states (such as approval of applications or notice of revocation of tax-exempt status), the IRS has no procedures in place for regular sharing.<sup>356</sup> State and federal regulators have differing priorities in monitoring charitable accountability. Finding a balance between the need for taxpayer privacy and sharing information by state and federal regulators could improve state efforts.

### *B. Patterns of Regulatory Change*

Though the attorney general historically has been responsible for charities' accountability, because of a lack of resources, the IRS has become the primary regulator of nonprofit behavior.<sup>357</sup> The IRS's Division of Tax-Exempt and Government Entities is responsible for regulatory oversight.<sup>358</sup> Initially, it can screen nonprofit organizations when they apply for recognition of tax-exempt status.<sup>359</sup> Thereafter, a small percentage of the Form 990 annual returns are examined.<sup>360</sup> In the past decade the number of applicants has doubled.<sup>361</sup> In 2001, 58,938 applications were received requesting recognition of section 501(c)(3) status.<sup>362</sup> Of those 10,548 were disposed of because the applicant did not submit a fee, did not submit all documents, or the application was withdrawn.<sup>363</sup> Of the 42,366 complete applications

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353. Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, 25 EXEMPT ORG. TAX REV. 413, 419 n.17 (1999).

354. GAO REPORT, *supra* note 6, at 26-29.

355. *Id.* at 26.

356. *Id.* at 28. I.R.C. § 6103 prohibits public disclosure of tax return data save where explicitly permitted. I.R.C. § 6103 (2000). Congress has pushed for more public disclosure of nonprofit records. See GAO REPORT, *supra* note 6, at 26-28.

357. See GAO REPORT, *supra* note 6, at 4.

358. *Id.* at 23.

359. *Id.* at 20.

360. See *id.* at 23 (discussing that all applications need to be processed by IRS agents, and with an increasing application workload the resources for performing examinations has decreased).

361. *Id.*

362. *Id.* at 21.

363. *Id.*

submitted, only 58 were denied!<sup>364</sup> From 1996 through 2001, the number of Form 990 annual returns filed with the Service increased by twenty-five percent (286,000) while the number examined dropped fifteen percent (to 1237).<sup>365</sup> The percentage of charities examined annually has fallen from .73 in 1998 to .43 in 2001.<sup>366</sup> The reasons for the decline are: changing Service priorities for other taxpayers, declining resources, and shifting of agents from examinations to cope with the increased number of applications.<sup>367</sup> This means that organizations who fill out the application in boilerplate fashion automatically will obtain recognition of exemption. Ultimately, the Service's lack of scrutiny may affect grants and contributions available to new organizations. Traditionally, the recognition of an exemption letter was a seal of approval to foundations and other donors. If the perception spreads that the IRS's scrutiny is pro forma, donor confidence will be affected.<sup>368</sup> Another way the Treasury Department and IRS encourage accountability is through the publication of treasury regulations, revenue rulings, revenue procedures, technical memoranda, private letter rulings, continuing educational publications for IRS staff and general counsel memoranda. This serves to educate fiduciaries and organizations and has an important function in promoting accountability and proper behavior. In recent years the Service has sharply scaled back this educative function with the result that charities and their counsel may not know what is appropriate in a particular situation.<sup>369</sup>

This is also a period of significant regulatory change. Traditionally, the IRS's focus has been upon issues related to the tax exemption. The intermediate sanctions legislation<sup>370</sup> has perhaps the unintentional result of preempting a traditional area of state regulation—oversight of the fiduciary duties of state chartered corporations.<sup>371</sup> As an enforcement mechanism, in contrast to its role as a

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364. *Id.*

365. *Id.*

366. *Id.* at 22.

367. *Id.* at 21-22.

368. See Elizabeth Schwinn & Grant Williams, *A Challenge for the IRS: Lack of Funds and Manpower Tax Agency's Ability to Regulate Charities*, CHRON. PHILANTHROPY, Aug. 23, 2001, at 1.

369. *Id.*

370. I.R.C. § 4958 (2000).

371. It is curious that this development has occurred when other legal impulses are moving regulatory activity toward the state level. In contrast to the federalization of charitable oversight, a new federalism emphasizing states' rights and limiting the power of Congress to pass laws that bind the states has emerged since 1995 in a series of Supreme Court decisions. See *United States v. Morrison*, 529 U.S. 598, 627 (2000) (holding that the civil

catalyst of normative change, its effectiveness is questionable. As yet, only two organizations, a medical organization in Mississippi and the Bishop Estate in Hawaii, have had taxes imposed under the legislation.<sup>372</sup> The Internal Revenue Service itself has been forced to reorganize and to soften its previous aggressiveness, which may lead to a different approach to enforcement.<sup>373</sup> In 2000, Congress held hearings and indicated that it wished nonprofits and the IRS to publicize heretofore private information, such as private letter rulings, settlement agreements, and disciplinary actions.<sup>374</sup>

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remedy provision of the Violence Against Women Act is neither a valid regulation of interstate commerce nor a proper means of enforcing equal protection guarantee of Fourteenth Amendment); *United States v. Lopez*, 514 U.S. 549, 551, 566-68 (1995) (holding that “the Gun-Free School Zones Act of 1990, . . . [which forbade] ‘any individual knowingly to possess a firearm at a place . . . [he] knows . . . is a school zone’” exceeded Congress’s Commerce Clause powers).

372. See *Caracci v. Comm’r*, 118 T.C. 379, 416 (2002) (holding that family members and directors of a Mississippi organization must return \$5.2 million in assets and refusing to grant the family members and directors an excise tax abatement); Carolyn D. Wright, *IRS Assesses Intermediate Sanctions Against the Bishop Estate Incumbent Trustees*, 31 EXEMPT ORG. TAX REV. 155 (2001).

373. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified in various sections of 5 U.S.C. & 26 U.S.C.).

374. Jennifer Moore & Grant Williams, *Congressional Panel Urges Greater Disclosure of Non-Profit Data by IRS*, CHRON. PHILANTHROPY, Feb. 10, 2000. The Staff of the Joint Committee on Taxation has published a report in which the joint staff indicates that disclosure of information regarding tax-exempt organizations is appropriate “unless there are compelling reasons for nondisclosure that clearly outweigh the public interest in disclosure.” STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOL. II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 80 (Comm. Print 2000). Furthermore, the efficiency of the tax-exempt sector will be improved by increased disclosure of information regarding these organizations by: “1) increasing public oversight of tax-exempt organizations; 2) increasing compliance with Federal tax and other applicable laws; 3) promoting the fair application and administration of the federal tax laws; and 4) advancing the policies underlying the Federal tax rules regarding said organizations.” *Id.* at 6.

Among the Joint Committee staff’s recommendations are: “all written determinations (and background file documents) involving tax-exempt organizations should be publicly disclosed” including audits, closing agreements without redactions of the organization’s name; applications for tax-exempt status of service action on it should be disclosed when the application is filed; Form 990 and related forms should be filed electronically after 2002; disclosure should be made of Forms 990-T (Exempt Organization Business Income Return and Form 1120-POL). *Id.* at 7. Internal Revenue Code section 527 organizations should have to file annual returns even if they have no taxable income; tax-exempt organizations should be required to provide both their legal name and the name they do business under, their web sites, and more information over fund transfers between and among tax-exempt organizations, *id.* at 96-98; and there should be increases in penalties for omissions and misrepresentation by preparers, as well as expended disclosure of returns to non-tax state officials or agencies such as the state attorney general. *Id.* at 101-05.

## V. IMPROVING CHARITABLE ACCOUNTABILITY

Holding fiduciaries accountable through an efficient enforcement procedure is an ongoing problem. It has long been demonstrated that state attorney general offices have neither the person-power, nor sometimes the will, to monitor nonprofits effectively.<sup>375</sup> In the words of Professor Harvey Dale, a long-time observer of the nonprofit world:

[G]overnment regulators (and most particularly attorneys general, to whom the law confides the principal role in policing charities) tend to allocate their scarce regulatory resources to other more politically potent portions of their domains. In most states, the Charity Bureau of the Attorney General is inactive, ineffective, overwhelmed, or some combination of these.<sup>376</sup>

Leading commentators on the nonprofit sector have offered suggestions to improve nonprofit accountability. One, Joel Fleishman, a former law professor at Duke University and foundation president, has urged the creation of a new federal regulatory agency for policing the nonprofit sector.<sup>377</sup> This is not a new recommendation. Professor Kenneth Karst suggested forty years ago, the creation of a new agency at the state level: a state board of private charities which would have primary responsibility for supervising private charities and for administering the various state controls over their operation.<sup>378</sup> The question remains whether on a state or federal level, a new agency will be any more likely to gain sufficient funding to make it an effective monitor of charities. In addition, will the creation of another government agency without the clout of the attorney general or the IRS be likely to improve accountability? Both prospects are doubtful.

Peter Swords, former President of the Nonprofit Coordinating Committee, an advocacy organization for charitable organizations, suggests that the sector advocate for "stronger generic oversight agencies," such as "stronger government regulatory agencies."<sup>379</sup> He rec-

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375. See MARION R. FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 221-28 (1965) (discussing tax inadequacies and the legislative attempts to solve them); Swords, *supra* note 353, at 413; SWORDS & BOGRAD, *supra* note 339.

376. Swords, *supra* note 353, at 413.

377. See Fleishman, *supra* note 202, at 172, 187-88. Marcus Owens, former head of the IRS's Exempt Organizations Division, also reiterated that view with the caveat that unless Congress was willing to devote substantial new money and numbers of staff, it is unlikely there would be any significant improvement. Schwinn & Williams, *supra* note 368, at 28.

378. Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 476-83 (1960).

379. Swords, *supra* note 353, at 413.

ommends that private nonprofit accountability groups work with state attorneys general and provide direct assistance to aid in meeting their goals, which does happen in several states.<sup>380</sup> In addition, he suggests that nonprofit groups make the Form 990 more effective as an accountability tool and help with advocacy campaigns aimed at providing more support for these agencies.<sup>381</sup> Swords also outlines a series of collaborative efforts.<sup>382</sup> Essentially, he promotes the idea of self-regulation with the securities industry as his model.<sup>383</sup>

Private groups can test, change, and improve norms.<sup>384</sup> The testing of the meaning and roles of current norms is an important role of such private organizations that lie between the citizen and the state.<sup>385</sup> In the nonprofit sector there are many such associations—Independent Sector, The Nonprofit Coordinating Committee of New York, and The Council on Foundations—to name a few. The breadth of the nonprofit sector and its depth, that is, the members of organizations within each subset, are so vast that private groups cannot produce sector-wide normative change on their own. Additionally, the history of self-regulation of the financial services sector in both the United Kingdom and the United States demonstrates that self-regulation by an industry is basically self-protection.<sup>386</sup> The success of the self-regulatory bodies in the securities industry has been due to the threat, both implicit and explicit, that failure to regulate will bring harsher governmental sanction. In fact, over the years in the United States and the United Kingdom, the securities statutory body has had to increase its authority over the self-regulating organizations.<sup>387</sup>

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380. *Id.* at 416-17.

381. *Id.* at 421.

382. *Id.* at 423.

383. *See id.* at 417 n.12 (noting the successful cooperation between the SEC and Self-Regulatory Organizations in policing the securities business).

384. Sunstein, *Social Norms and Social Roles*, *supra* note 177, at 947.

385. *Id.*

386. Over the last sixty-five years the Securities and Exchange Commission (SEC) has exerted increasing authority over self-regulatory organizations. *See* JAMES J. FISHMAN, *THE TRANSFORMATION OF THREADNEEDLE STREET: THE DEREGULATION AND REREGULATION OF BRITAIN'S FINANCIAL SERVICES* 54-55, 298-99 (1993) (noting the problems with self-regulation and praising the American approach, which authorizes the SEC to allocate examination authority to SRO); David A. Lipton, *The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets*, 16 U.C. DAVIS L. REV. 527, 528-29 (1983) (describing the history of the SEC's intended regulatory role); *see also* Karen Talley, *Levitt Expects Wall Street to Fall Short*, WALL ST. J., July 24, 2001, at C13 (noting that the former head of the SEC expects little from Wall Street's efforts to police itself).

387. *See, e.g.*, Lipton, *supra* note 386, at 533-34 (describing the expansion of the SEC's role).

A. *The Potential of Technology for Improving Accountability: The Internet*

The internet offers enormous possibilities for improving accountability and regulatory oversight, and has already had a substantial impact on charities who use their websites to advertise, sell, provide information, and raise funds.<sup>388</sup> More than anything else, the internet may increase the focus upon nonprofit fiduciary behavior. Every individual with access to the web can become a sentry of nonprofit behavior. It is now possible to scrutinize most charitable organizations with an intensity that seemed unimaginable even five years ago. Thus, while the formal regulatory regime has centralized,<sup>389</sup> technology can move citizen oversight to a local fulcrum. While individuals cannot strip an organization of exemption or except in unusual situations, bring suit, the citizen-sentry can raise the alarm by withholding contributions, creating reputational damage, and alerting the press or appropriate governmental officials.

Though the internet presents a new level of transparency to charitable operations, it does nothing in and of itself to improve the enforcement of nonprofit fiduciary standards. In fact, the internet has exacerbated the problems of enforcement and accountability. No longer are nonprofits under the radar beam of critical scrutiny, but the lack of accountability and dearth of enforcement resources may further damage the reputation of the nonprofit sector.

B. *Increased Federal Disclosure and Inspection Mandates*

The development of the internet has coincided with a continuing effort by the federal government to make exempt organizations more accountable to the public. Congress has enacted and expanded a variety of public disclosure and inspection requirements that apply to both the IRS and the organization. The IRS must make available for public inspection at the National Office and the appropriate field offices all Form 990s, section 501(c)(3) organizations' annual report and approved Form 1023 applications for exemption.<sup>390</sup>

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388. Thousands of charities' Form 990s can be viewed on line. See *infra* note 400 (providing an illustration).

389. See *supra* notes 257-276 and accompanying text (discussing the intermediate sanctions legislation, which regulates excessive benefits to insiders, traditionally a state function).

390. I.R.C. § 6104(a)(1)(A), (b) (2000). Trade secrets and information that would adversely affect national defense are exempt from disclosure, as is the schedule of major contributors that is required as an attachment to the Form 990. *Id.* § 6104(a)(1)(D), (b).

All organizations<sup>391</sup> exempt from tax under sections 501(c) or 501(d) must make available for inspection their application for exemption, along with all supporting documents,<sup>392</sup> and their annual informational returns for the most recent three years.<sup>393</sup> The documents must be made available at the organization's principal office during regular business hours and at regional or district offices with three or more employees.<sup>394</sup> Tax-exempt organizations also must provide copies of their exemption applications and Form 990s for the three most recent tax years to anyone who requests them.<sup>395</sup> The copies ordinarily must be provided immediately if the request is made in person or within thirty days if in writing.<sup>396</sup>

Organizations that make their documents "widely available," such as by posting an exact and downloadable reproduction on a world wide web site, are not required to provide photocopies, but they still must make returns available for inspection at their offices.<sup>397</sup> In expanding the disclosure requirements, Congress was mindful that some highly visible charities would be the target of harassment campaigns, and it authorized the IRS to issue regulations providing relief in appropriate cases.<sup>398</sup>

Additionally, the IRS is in the process of putting information returns of all section 501(c)(3) organizations on CD-ROMs for sale to the public on a subscription basis.<sup>399</sup> The Guidestar Directory of Philanthropic Research, Inc. already posts information of thousands of charities on its web page.<sup>400</sup> However, full transparency is but half of the issue. An accountability system is only as good as its enforcement mechanism.<sup>401</sup> Unless an effective enforcement mechanism is tied to

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391. Private foundations are subject to similar disclosure and inspection requirements. Treas. Reg. § 301.6104(d)-1 to (d)-3 (2002).

392. I.R.C. § 6104(d)(1)(A)(ii).

393. *Id.* § 6104(d)(1)(A)(i), (d)(2).

394. *Id.* § 6104(d)(1)(A).

395. *Id.* § 6104(d)(1)(A)(ii)-(iii), d(2).

396. *Id.* § 6104(d)(1)(B). Under prior law, requestors could only inspect these documents at the organization's office and had no right to demand copies. Now if a copy is requested, the organization may charge for reasonable copying and mailing costs. Treas. Reg. § 301.6104(d)-1(d)(3)(i).

397. I.R.C. § 6104(d)(4); Treas. Reg. § 301.6104(d)-2.

398. See I.R.C. § 6104(d)(4). These regulations define a harassment campaign as "a single coordinated effort to disrupt the operations of a tax-exempt organization, rather than to collect information about the organization." Treas. Reg. § 301.6104(d)-3(b).

399. See David Cay Johnston, *Tax Returns of Charities to be Posted on the Web*, N.Y. TIMES, Oct. 18, 1999, at C1 (noting that The Urban Institute gave the IRS nearly \$1 million over five years, beginning in 1999, to scan charity returns onto CD-ROMS).

400. See <http://www.guidestar.org> (last visited Nov. 7, 2002).

401. Swords, *supra* note 353, at 413.

the transparency provided by the internet, the advantage of additional scrutiny is minimized.

#### VI. A PROPOSAL TO INCREASE ACCOUNTABILITY: ADVISORY CHARITY COMMISSIONS UNDER THE AEGIS OF THE ATTORNEY GENERAL

It is doubtful that there will be a substantial increase in funding for enforcement activity at either the federal or state levels. The only realistic way to increase nonprofit accountability and to create new norms of fiduciary behavior is to leverage existing regulators' efforts by making them more efficient, and in a variant of Swords's and Fleishman's more general proposals, to use private citizens in the service of state attorneys general. It is better for the nonprofit sector and for the efficiency of regulation for its locus to be at the state rather than federal level. Almost all charities are incorporated at the state level and have state domiciles. Historically, fiduciary norms have been matters of state law. Moreover, at the state or a more local level, regulation is at a more meaningful scale where members of the charity's community can monitor, educate, and put into play the legal mechanisms that institute accountability. Professor Sunstein has suggested that "it is probably best to have a presumption in favor of the lowest possible level of government [because] it is closest to the people, and in that sense most responsive to it and most likely to be trusted."<sup>402</sup> Local efforts are more responsive to our constitutional structure of federalism, which increased federal regulation undermines.

This proposal recommends the creation of advisory commissions under the ultimate supervision of the state attorney general. The advisory commission structure and procedure, which will be set forth below, has some similarities to a commission procedure established under the seminal Statute of Charitable Uses of 1601,<sup>403</sup> and to contemporary lawyer and judicial disciplinary bodies.

##### A. *Proposed Charity Commission Procedures*

To harness the transparency offered by the internet, local charity commissions should be the initial filter for citizen complaints. The commissions would serve under the control and guidance of the state attorney general. In states with a substantial number of charities such as New York or California, charity commissions could be established on the basis of state judicial divisions. Thus, New York, having four appellate divisions, would have four charity commissions. The charity

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402. Sunstein, *Social Norms and Social Roles*, *supra* note 177, at 952.

403. 43 Eliz., c. 4 (Eng.).



commissions would be public-private partnerships which would be imbued with a legal and moral authority that a wholly private body or state agency could not engender. They also could serve an educational or remedial, norms inculcation function more easily than a governmental enforcement agency alone.

Each charity commission would consist of fifteen unpaid citizens, eight appointed by the governor and seven by the attorney general.<sup>404</sup> Some would be individuals experienced in the nonprofit sector or beneficiaries of nonprofit organizations' activities. Others would be members of the general public. The chief administrator of each commission would be an assistant attorney general.<sup>405</sup> Commissioners would be appointed for three-year terms, which would be renewable once.<sup>406</sup>

A person could complain about a charity or its official, and she would provide to the commission or its staff information to validate the allegations. The commission would have the powers to investigate, hold hearings, and subpoena witnesses and evidence. Thereafter, it could issue a report exonerating the charity or individual, resolve the problem by working with the charity, recommend the charity to a service organization that might provide assistance, or turn the matter over to the attorney general for routine prosecution. This remedial function could be the most important effect of the charity commission process, for cumulatively it could inculcate new sector-wide norms of behavior.

When a complaint comes into the charity commission, a panel of three commissioners, randomly selected, would review the allegations and the evidence. If the charges were in any way colorable, the allegations and evidence would be turned over by the commission to the assistant attorney general who would promptly serve a copy of the complaint on the accused organization or individual or any other necessary parties and make a preliminary investigation. The assistant attorney general will determine whether the charity commission or the attorney general should have jurisdiction over the matter alleged. If she has probable cause to believe the allegations to be true, the assistant attorney general would be responsible for initially subpoenaing

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404. There is precedence for such cooperation. In New York, the Governor and Attorney General can appoint a deputy attorney general to head an organized crime task force. N.Y. EXEC. LAW § 70-a(2) (McKinney 2002).

405. The attorney general and other agencies could loan officials, but the legislature should appropriate a sum for maintenance of the office.

406. For the initial appointment of the commissioners, five would be appointed for three years, five for two years and five for one year, thereby creating a staggered board.

witnesses and evidence which would be presented to the three-person commission. Allegations of wrongdoing would be heard by the three commissioners, who could dismiss the charge, seek additional information, or place the matter before the full commission.

In the words of Judge Learned Hand, "indictments are calamities to honest men."<sup>407</sup> This is also true for charities. Public investigations are disasters for a charity's reputation. Thus, commission investigations and hearings would be confidential, and a prime role of the charity commissions shall be to engage in settlement, conciliation, and remediation if necessary, to remove the force of the allegations. It is assumed that many wrongdoings of charities flow out of nonfeasance or ignorance. The three-person commissions could provide direction and assistance in bringing the charity into compliance with procedures, mandates, or law. Under the resolution process, the charity and the commission would sign a settlement agreement whereby the charity would admit any wrongs, indicate changes it will make to bring itself into compliance, and agree to present a report within twelve months of the agreement date outlining the implementation of the suggested changes. These proceedings and settlement would not be made public.

If a settlement cannot be reached or there is probable cause for the allegations, the three panel commissions will elect, by majority vote, to turn the matter to the full commission for a hearing. The hearing before the full commission also shall be *in camera*. The organization or individual (hereinafter called "respondent") may file a written answer and appear with or without counsel. If the respondent fails to appear, a default judgment shall be entered, and the matter will be turned over to the attorney general for enforcement.

Upon the conclusion of the hearing by the full commission, the matter could be dismissed, settled, or an order could be issued requiring the respondent to take certain steps to implement compliance, pay costs of investigation, and provide a compliance report. If the commission finds the respondent innocent of such charges, it shall issue an order dismissing those findings which shall also be transmitted to the attorney general. This report shall not be made public. If the full commission finds the allegations are correct and no settlement has been reached or order complied with, the matter shall be turned over to the attorney general who will handle it as part of its normal oversight of charities.

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407. *United States v. Garsson*, 291 F. 646, 649 (S.D.N.Y. 1923).

When an individual or an organization is summoned before a three-member panel or the full commission, it may challenge the presence of any of the commissioners for a conflict of interest. If such conflict is found by the other members of the commission, the particular commissioner must recuse herself from hearing the matter. Annually, the charities commissions shall issue a report summarizing the number of matters brought to it and their method of disposition.

An underlying assumption of these advisory charity commissions is that local enforcement by citizens in the community is the most efficient and effective method of providing accountability and for providing support and encouragement of the charitable sector. There are current analogies in the areas of attorney and judicial discipline that are useful in terms of procedure and the litigation of private citizens backed by the authority of the state.

### *B. Three Analogies to the Proposed Charity Commissions*

1. *Charity Commission Procedures Under the Statute of Charitable Uses.*—The Statute of Charitable Uses<sup>408</sup> was a seminal development in the law of philanthropy and remains important today. Its roots lay in the inadequacy of the existing Chancery Court procedure to ensure fiduciary accountability. It also complemented the Poor Law passed the same year.<sup>409</sup> In order to encourage philanthropic aid to the poor, some effective system of oversight had to be created.<sup>410</sup> Though the Statute's preamble subsequently became more famous, the legislation primarily created a procedure for the efficient administration of charitable trusts and bequests, which, heretofore, had been lacking.<sup>411</sup> Additionally, it codified and extended the legal underpinning of the charitable trust and solidified the role of the Chancellor in overseeing charitable assets.<sup>412</sup> The preamble, which undertook the recital of the

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408. The Charitable Uses Act, 1601, 43 Eliz., c. 4 (Eng.).

409. An Act for the Relief of the Poor, 1601, 43 Eliz., c. 2 (Eng.). Relief of the poor paid by taxes at the parish level would come into play only if private donations failed to meet the need.

410. See JONES, *supra* note 8, at 21-22 (explaining that “[w]hat was needed was a general procedure which would supplement the traditional Chancery procedure, which would . . . protect charity and which would ensure the application, in accordance with the intent of the donors, of those charitable uses . . .”).

411. *Id.* at 12-13, 25. The preamble became the source for the common law definition of “charitable” activity. See 38 PARL. DEB. (1st ser.) (1818) 603.

412. The statute remained on the books until 1888, but the successor statute preserved the preamble's definitions of charitable activity as has the case law. See *Comm'r of Income Tax. v. Pemsel*, [1891] 1 A.C. 531, 532 (holding that “charitable purposes” were wider than just those that gave relief to the poor).

proper objects of charitable interest, eventually became the source for the scope of meaning of the word "charitable."<sup>413</sup>

The Statute provided for an administrative procedure that enabled the crown "to initiate and sustain a thorough investigation of charitable uses [to ensure] that their endowments might be 'duly and faithfully employed' in accordance with the intent of the donors."<sup>414</sup> It created inquisitory procedures whereby five commissioners "were appointed to inquire into 'any breach of trust, falsity, non-employment, concealment, or conversion' of charitable funds" in the county specified within their commission.<sup>415</sup> Thus, the investigation occurred at the local level,<sup>416</sup> and it required a strong and effective parish government. Parishioners were invited to furnish evidence of breaches known to them, and the commissioners, on the inquisition of a jury, would issue a decree correcting any breach.<sup>417</sup> An appeal subsequently could be lodged with the Chancellor.<sup>418</sup>

Once the decree was issued, the local parishes of the county were given notice of the commission and encouraged to bring with them any evidence necessary to address their allegations that charitable property had been misused.<sup>419</sup> According to Professor Gareth Jones, the notice served as an encouragement for parishioners to report "to the commissioners breaches of trust of which they were aware" and bring the documents necessary to "substantiat[e] their allegations."<sup>420</sup> The procedure under the statute encouraged local monitoring, inves-

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413. JONES, *supra* note 8, at 25.

414. *Id.* at 22-23.

415. *Id.* One of the five commissioners had to be a bishop. *Id.* at 40. The other commissioners had to be "'persons of sound or good behavior' who, if not Justices of the Peace, were invariably gentlemen of the country." *Id.* (footnotes omitted). One could not be a commissioner, however, if there was any interest or claim in the property that was the subject of the investigation. *Id.* at 40, 42.

416. *Id.* at 41-42. The leading exposition of the statute was by Francis Moore, a member of the House of Commons and drafter of the legislation. *Id.* at 27-31. His "Reading" or lectures to the students of Gray's Inn is the leading contemporary analysis of the procedure. The "Reading" is reprinted in GEORGE DUKE, *THE LAW OF CHARITABLE USES*, c. VII (London, W. Clarke & Sons, 1805) (1676). Professor Jones has used and relied on Moore's analysis. JONES, *supra* note 8, at 27-31.

417. JONES, *supra* note 8, at 41.

418. *Id.* at 45. If the charitable use was not within the statute's preamble, an alleged abuse would be prosecuted at common law in the name of the attorney general or by an original bill brought by an individual with standing. *Id.* at 33. Charitable uses not within the statute included lands, rents, etc., given to certain colleges, towns, and schools as well as most religious uses. *Id.* at 27-31.

419. *Id.* at 41.

420. *Id.*

tigation, and ultimately punishment or a remedy that would be locally applied.<sup>421</sup>

If there was evidence of mis- or non-feasance, a warrant was then issued to the sheriff of the county requiring the assemblage of a jury.<sup>422</sup> According to Professor Jones, “[a]t the hearing, . . . the commission would be read, the sheriff would return his writ summoning the jury, [and] the jury [then] would be [charged].”<sup>423</sup> Interested parties would make their challenges to the jury.<sup>424</sup> Thereafter, the jury would be sworn to inquire what property had been devolved to charitable uses enumerated in the preamble to the statute and what breaches of trust had been committed.<sup>425</sup> It would hear evidence, find in the inquisition “the gift,” and any negligence or misemployment of that gift.<sup>426</sup> Based on the inquisition by the commissioners, a decree was returned “into the Court of Chancery within the time specified in the original commission.”<sup>427</sup> The commissioners’ extensive powers “were directed to ensuring that property devoted to . . . charitable uses . . . was employed in accordance with the intention of the donors.”<sup>428</sup> Their powers were limited only by good faith.<sup>429</sup> Parties aggrieved by the commissioners’ findings could appeal by bill to the Chancellor.<sup>430</sup> The commissioners seemed a combination of grand

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421. *Id.* at 47. The chancellor, for example, had authority to impose fees against those who had complained “without just and sufficient cause” and award costs to their opponents. 43 Eliz., c. 4 (Eng.).

422. JONES, *supra* note 8, at 44. The sheriff would summon the churchwardens and officers of the parishes, and all interested parties. *Id.* According to Moore, an interested party was described as:

[one] who . . . would be affected either directly or indirectly by the commissioners’ decree . . . includ[ing] a donor; the donor’s heirs, feoffees or executors; a grantee of the land charged with a charitable use, or his heirs; a person who had power to nominate charitable uses under the trust, and the Ordinary[—a bishop or other ecclesiastic in his capacity as an *ex officio* ecclesiastical authority,] if he . . . [who had given rise] to a charitable use, die[d] intestate.

*Id.* at 42-43 (footnotes omitted). Interested parties could also challenge the commissioners and the jurors. *Id.* at 43. This distinguished the act of 1601 from its predecessor, the Charitable Uses Act of 1597, 39 Eliz., c.6 (Eng.), which did not explicitly allow for any challenge to jurors. *Id.* The absence of the right to challenge was the principal reason it was not renewed. For allowable challenges, see DUKE, *supra* note 416, at 144-51.

423. JONES, *supra* note 8, at 44 (footnote omitted).

424. *Id.* at 43.

425. *Id.* at 44-45.

426. *Id.* at 44.

427. *Id.* (footnotes omitted).

428. *Id.* at 47.

429. *Id.*; see also DUKE, *supra* note 416, at 152-66.

430. JONES, *supra* note 8, at 45. The appeal had to be in writing “excepting . . . to the commissioners’ order and decree. To these exceptions, the [opposing] . . . party . . . could furnish written answers.” *Id.* After hearing the exceptions, the Chancellor could use his

jury and master, rather than a substitute for the attorney general.<sup>431</sup> They always were subject to the supervision of the Chancellor who, with the advice of common law judges, determined the powers of the commissioners.<sup>432</sup> The commissioners assured that charitable assets were applied to their proper use.

From 1597 to 1625, over one thousand decrees involving charitable trusts were issued as compared to one or two made by the Chancellor annually from 1400-1601.<sup>433</sup> Professor Jones suggests that the commissioners' success was due to the Chancellor's support of the procedure, the support of the parish community, and the fact that the hearings were local.<sup>434</sup> This may be a message for the present—local monitoring.

In the period of the English Civil War and Interregnum (1640-1660), there were far more important issues to be resolved than the proper use of charitable assets, and utilization of the charity commission procedure declined.<sup>435</sup> Though a short revival occurred from 1670 to 1688,<sup>436</sup> another procedure came into private use. Instead of the commission procedure which depended upon the energy and good will of neighbors, petitioners on behalf of charities now used the "information," an appeal to the attorney general.<sup>437</sup> Thereupon, the attorney general as relator sought to enforce charitable trusts on behalf of an aggrieved individual or charity through an action in Chan-

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equity powers in fashioning a decree—ordering specific performance, restitution, or charging interest. *Id.* at 46. There was no appeal from an action of the Chancellor because the decree was by order of Parliament. *Id.* The commissioners could require the "feoffees," the beneficiaries of the trust, "to pay costs to . . . person[s] who successfully prosecuted the reform of the charitable trust" and to successful exceptants. *Id.* at 46-47. While they could limit the charitable use to comply with the donor's intent, the commissioners could not change it or exercise powers of *cy pres* or exercise the variance power. *Id.* at 49-50.

431. *Id.* at 46-51.

432. *Id.* at 51.

433. *Id.* at 52.

434. *Id.* at 52-53.

435. See DAVID OWEN, ENGLISH PHILANTHROPY 1660-1960, at 85 (1964).

436. Because the docket books were destroyed, it is difficult to accurately estimate the use of the commission procedure up to 1643, but for the next century the figures are precise and show a steady decline: 1643-1660: 295; 1660-1678: 344; 1678-1700: 197; 1700-1746: 125; 1746-1760: 3; 1760-1818: 6; and after 1787: 0. *Id.* (citing Lord Brougham in Parliament, 38 PARL. DEB. (1st ser.) (1818) 606-07).

437. JONES, *supra* note 8, at 36 (stating "each information . . . set out reasons why the particular charity was . . . relievable [by the court]).

cery.<sup>438</sup> This was felt to be a more efficient procedure, and the commission procedure fell into disuse.<sup>439</sup>

2. *Attorney Discipline.*—The hearings by a charity commission are a form of disciplinary proceeding. Attorney disciplinary procedures provide a partial, albeit imperfect analogy to the proposed charity commissions.<sup>440</sup> They involve governmental-private partnerships with the supreme court of the jurisdiction ultimately responsible for attorney discipline in partnership with the bar and the public.<sup>441</sup> Although state procedures, effectiveness, record keeping, and application of standards differ widely,<sup>442</sup> attorney discipline provides guidance on the need for procedural protection and privacy as well as the aims of such sanctions. Discussed herein are the Model Rules for Lawyer Disciplinary Enforcement and New York Law; although, other jurisdictions easily could be substituted.

Under the Model Rules, the highest court of the state has responsibility for lawyer discipline, which is delegated to a statewide disciplinary agency with a statewide board.<sup>443</sup> The board should have appropriate diverse representation of all members of the public.<sup>444</sup> The New York Judiciary Law provides that the Supreme Court has “power and control over attorneys” and grants to the Appellate Division of the Supreme Court in each of the four judicial departments the authority to conduct disciplinary proceedings relating to attor-

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438. *Id.* By this time, many of the commission proceedings wound up in Chancery on appeal, so one of the initial advantages, an expeditious hearing, was lost. OWEN, *supra* note 435, at 85. The last commission, used in 1787, was not executed until 1803. *Id.* The next year, “Chancery was petitioned to confirm the commissioner’s decree. But exceptions were taken,” and it took four years before the case was submitted to the court for decision. *Id.* Then, Lord Chancellor (Eldon) sat on the case for a decade. *Id.*

439. JONES, *supra* note 8, at 55.

440. The scope of attorney discipline is much larger than the caseload expected for charity commissions. In 1996, state lawyer disciplinary committees reported 118,891 complaints with about five percent of the complaints resulting in sanctions. ABA CTR. FOR PROF’L RESPONSIBILITY, STANDING COMM. ON PROF’L DISCIPLINE, SURVEY ON LAWYER DISCIPLINE SYSTEMS 1996, at 4 (1998). Ten states did not provide data. *Id.* In 1998, in New York’s First Department, which encompasses Manhattan and Bronx counties, stated that in 1998 there were 953 complaints to the disciplinary committee resulting in 28 disbarments, 47 suspensions, and twelve public censures. DEPARTMENTAL DISCIPLINARY COMM. OF THE APP. DIV. OF THE STATE OF N.Y., 1998 ANNUAL REPORT 36, 43 (1999) [hereinafter DISCIPLINARY COMM. ANNUAL REPORT].

441. MODEL RULES FOR LAWYER DISCIPLINARY ENFORCEMENT R. 2(A)-(B) (1996).

442. See generally Leslie C. Levin, *The Emperor’s Clothes and Other Tales About the Standards for Imposing Lawyer Discipline Sanctions*, 48 AM. U. L. REV. 1 (1998) (providing an overview of the goals and standards of attorney discipline).

443. MODEL RULES FOR LAWYER DISCIPLINARY ENFORCEMENT R. 2 cmt.

444. *Id.*

neys.<sup>445</sup> As is common in most jurisdictions, a court, (in New York the Appellate Division of the Supreme Court), appoints a Departmental Disciplinary Committee, which has the responsibility of investigating, prosecuting, and disciplining matters involving alleged misconduct by attorneys and law firms.<sup>446</sup> The court, along with the Departmental Disciplinary Committee, then selects a chief counsel and necessary staff.<sup>447</sup>

The primary purpose of attorney discipline proceedings, along with the charity commission proposal, is protection of the public.<sup>448</sup> At the same time, the disciplinary process stands ready to defend attorneys against unmerited charges.<sup>449</sup> The charity commission will serve a similar role for nonprofit organizations. Because disciplinary procedures are civil in nature, the full panoply of procedural due process rights do not apply, but an accused attorney has the right to notice of charges, an opportunity to be heard, and the right to be represented by counsel.<sup>450</sup>

A disciplinary counsel initially evaluates a complaint with notice to the respondent.<sup>451</sup> Upon conclusion of an investigation, the disciplinary counsel may dismiss the complaint; refer a respondent to an Alternatives to Discipline Program; or recommend probation, admonition, formal charges, transfer to disability inactive status, or a stay.<sup>452</sup> In New York, the initial investigation is undertaken by the Office of

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445. N.Y. JUD. LAW § 90(2) (McKinney 2002). In New York, the Supreme Court is the basic court for jurisdiction. The Appellate Division of the Supreme Court is the intermediate court of appeal and the Court of Appeals is New York's highest court.

446. N.Y. COMP. CODES R. & REGS. tit. 22, § 603.4 (2002). At least two-thirds of the committee must be attorneys. *Id.* Appointment is for a three-year term. *Id.* After appointment for two consecutive terms, a member is not re-eligible for reappointment for one year. *Id.*

447. *Id.*

448. *Mitchell v. Ass'n of the Bar*, 351 N.E.2d 743, 745 (N.Y. 1976) (noting the public protection aspect of disbarment proceedings).

449. MODEL RULES OF LAWYER DISCIPLINARY ENFORCEMENT R. 2.

450. Each of the four New York Appellate Divisions has rules for the establishment of disciplinary committees whose charge it is to investigate instances of professional misconduct. *See, e.g.*, N.Y. COMP. CODES R. & REGS. tit. 22, § 605 (2002) (providing rules for the First Department). Charges made in a letter to a grievance committee are absolutely privileged. *See infra* notes 463-471 and accompanying text (discussing confidentiality). Complaints of alleged attorney misconduct must be in writing and contain a concise statement of the facts. N.Y. COMP. CODES R. & REGS. tit. 22, § 605.6(b). In connection with the investigation, the Committee may obtain subpoenas for the attendance of persons or the production of books and records. *Id.* § 605.13.

451. MODEL RULES OF LAWYER DISCIPLINARY ENFORCEMENT R. 15(b).

452. *Id.* R. 11.



Chief Counsel of the Disciplinary Committee.<sup>453</sup> Except where there is no basis for proceeding, the Office of Chief Counsel transmits notice to the respondent advising her of the nature of the grievance and her right to state her position with respect to the allegations.<sup>454</sup> Following the investigation of the complaint, the office of the chief counsel may recommend: (1) referral to another body because of lack of jurisdiction; (2) dismissal; (3) admonishment;<sup>455</sup> or (4) formal proceedings before a hearing panel.<sup>456</sup>

If after the investigation, it is determined that there is reason to believe that professional misconduct has occurred, the Office of Chief Counsel institutes a formal disciplinary proceeding, and serves written charges of misconduct against the attorney, and requests the court to appoint a referee or hearing panel.<sup>457</sup> At the hearing all relevant evidence is admissible; the committee and respondent can summon witnesses and require production of books and papers.<sup>458</sup> Hearings are closed to the public.<sup>459</sup> If any of the charges are sustained, the hearing panel may: (1) issue a reprimand; (2) refer the matter to the court with a recommendation as to censure, suspension, or disbarment; or (3) issue a reprimand and refer the matter to the court with a recommendation as to censure, suspension or disbarment, and a recommendation as to restitution or costs.<sup>460</sup> In most Departments the committee alternatively may issue an admonition in those instances where the professional misconduct does not warrant referral to a

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453. N.Y. COMP. CODES R. & REGS. tit. 22, § 605.6(a). In the First Department, the complaint will be screened by a senior staff attorney who makes a preliminary recommendation as to whether the matter should be referred to another public agency or disciplinary committee, rejected, or investigated further. *Id.* § 605.6(e).

454. *Id.* § 605.6(d).

455. *Id.* § 605.6(e)(1)-(3). In the Second Department, a letter of admonition is issued when an investigation reveals that a lawyer has violated the Code of Professional Responsibility but not seriously enough to warrant a more severe sanction. *Id.* § 691.6(a). Although a letter of admonition is private and confidential, it becomes part of the lawyer's permanent disciplinary record. *Id.* § 691.6(b).

456. *Id.* § 605.6. All First Department dismissal recommendations are reviewed by a departmental disciplinary committee member. *Id.* § 605.6(f)(2).

457. *Id.* § 605.12. In the First Department, the matter would be assigned to a referee who would present a report to a hearing panel. *Id.* § 605.13.

458. *Id.* §§ 605.13, 605.17. In the First Department, the Hearing Panel does not conduct the evidentiary hearing but reviews the full record of the proceedings as well as the Referee's Report and Recommendation. *Id.* § 605.14. It then deliberates and issues a report containing its determination. *Id.* § 605.14(g).

459. See N.Y. JUD. LAW § 90(10) (McKinney 2002).

460. N.Y. COMP. CODES R. & REGS. tit. 22, § 605.13.

court.<sup>461</sup> The committee may issue a letter of caution when it is believed that the attorney acted in a manner which, while not constituting clear professional misconduct, involved behavior requiring comment.<sup>462</sup>

*a. Confidentiality.*—The Model Rules provide confidentiality only until a finding of probable cause at which point records and proceedings become public.<sup>463</sup> However, “[d]isability proceedings remain confidential until the final order of the court.”<sup>464</sup> The justification for waiving confidentiality is that “once a finding of probable cause exists, there is no longer a danger that the allegations against the respondent are frivolous.”<sup>465</sup>

Section 90(10) of the New York Judiciary Law provides strict standards for confidential treatment of attorney discipline proceedings.<sup>466</sup> The statute mandates that attorney disciplinary documents be deemed “private and confidential,” unless for cause shown the Appellate Division determines to divulge some or all of the record, until after a judicial determination that public discipline is in order.<sup>467</sup> Though there have been periodic efforts in New York to institute a fully-public disci-

461. See, e.g., *id.* § 603.9 (explaining admonishments in the First Department). The Second Department considers a reprimand to be discipline imposed by the committee after a hearing. *Id.* § 691.6.

462. See *id.* § 691.6 (noting the Second Department’s admonishment process). An attorney has the right to request a hearing upon receiving a letter of caution or an admonition. *Id.*

463. MODEL RULES OF LAWYER DISCIPLINARY ENFORCEMENT R. 16 (1996).

464. *Id.* cmt.

465. *Id.*

466. N.Y. JUD. LAW § 90(10) (McKinney 2002). New York law provides:

Any statute or rule to the contrary notwithstanding, all papers, records and documents upon the application or examination of any person for admission as an attorney and counselor at law and upon any complaint, inquiry, investigation or proceeding relating to the conduct or discipline of an attorney or attorneys, shall be sealed and be deemed private and confidential. However, upon good cause being shown, the justices of the appellate division having jurisdiction are empowered, in their discretion, by written order, to permit to be divulged all or any part of such papers, records and documents. In the discretion of the presiding or acting presiding justice of said appellate division, such order may be made either without notice to the persons or attorneys to be affected thereby or upon such notice to them as he may direct. In furtherance of the purpose of this subdivision, said justices are also empowered, in their discretion, from time to time to make such rules as they may deem necessary. Without regard to the foregoing, in the event that charges are sustained by the justices of the appellate division having jurisdiction in any complaint, investigation or proceeding relating to the conduct or discipline of any attorney, the records and documents in relation thereto shall be deemed public records.

*Id.*

467. *Id.*

plinary process after a formal complaint has been made,<sup>468</sup> and other jurisdictions permit public access when complaints are dismissed before formal charges.<sup>469</sup> New York has made no move to provide such access. There are similar confidentiality policies governing other New York statutes that regulate professions.<sup>470</sup>

However, in a majority of states open proceedings occur at an early time in the disciplinary process—when a determination to bring formal charges has been made.<sup>471</sup> If this model was applied to the proposed charity commission procedure, formal charges referred to the attorney general would presumably become public. This may not be as beneficial in the nonprofit sector, because the organization may be an innocent party and publicity could be disastrous for the organization. Therefore, the New York approach may be more suitable.

3. *State Commissions on Judicial Conduct.*—Another useful analog/89 to the proposed attorney general's charity commission is state commissions of judicial conduct. Commissions of judicial conduct offer a forum for citizens with conduct-related complaints, and a means of disciplining judges who transgress ethical constraints.<sup>472</sup> Though the Model Rules on Judicial Conduct and the New York State Commission on Judicial Conduct are used as examples, all fifty states and the District of Columbia have adopted a commission system to meet the above-mentioned goals.<sup>473</sup>

a. *The Model Rules.*—The Model Rules for Judicial Disciplinary Enforcement promulgated by the American Bar Association Center for Professional Responsibility and State Justice Institute are similar in structure to the Lawyer Disciplinary Rules. They envisage the creation of a Commission on Judicial Conduct composed of twelve members, from judges appointed by the state's highest court, four members of the bar appointed by the state bar association, and four non-lawyer members of the public appointed by the governor.<sup>474</sup> The

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468. See Ass'n Bar City New York Comm. on Prof'l Discipline, *The Confidentiality of Disciplinary Proceedings*, 47 Rec. 48, 49-52 (1992).

469. See *Sadler v. Or. State Bar*, 550 P.2d 1218, 1220-21 (Or. 1976) (finding state public records law applicable to bar association records of complaints against attorneys).

470. See N.Y. EDUC. LAW § 6510(e) (McKinney 2001) (providing liberal disclosure); N.Y. JUD. LAW § 44(4) (McKinney 2002) (discussing the confidentiality of hearings of judges); N.Y. PUB. HEALTH LAW § 230(11)(a) (McKinney 2002) (discussing the confidentiality of investigations of professional medical conduct investigations).

471. Comm. On Prof'l Discipline, *supra* note 468, at 51.

472. MODEL RULES FOR JUDICIAL DISCIPLINARY ENFORCEMENT R. 2(B)(2) (1999).

473. N.Y. STATE COMM'N ON JUDICIAL CONDUCT, 2001 ANNUAL REPORT 54 (2001).

474. MODEL RULES FOR JUDICIAL DISCIPLINARY ENFORCEMENT R. 2(C).

Model Rules provide for the appointment of a disciplinary counsel who conducts preliminary investigations, conducts full investigations, and after an investigative panel so determines, files formal charges.<sup>475</sup> Disciplinary counsel also serves as a filter to screen complaints.<sup>476</sup> The Commission is divided into hearing panels which *inter alia* “review the recommendations of disciplinary counsel after full investigation and approve, disapprove, or modify the recommendations.”<sup>477</sup> The rules separate the investigative and adjudicative factors by having separate panels.<sup>478</sup> In the case of the charity commission, there is not a formal separation but a referral to the attorney general if there is to be adjudicative proceedings. As with the Lawyer Disciplinary Rules, confidentiality of judicial disciplinary proceedings ends with the filing of formal charges on grounds of “the public’s right to know.”<sup>479</sup>

*b. New York Procedures.*—The New York State Commission on Judicial Conduct is composed of eleven members serving four-year terms.<sup>480</sup> Four are appointed by the governor, three by the Chief Judge of the Court of Appeals (New York State’s highest court), and one each by each of the four leaders in the legislature.<sup>481</sup> The Commission has the authority to receive and review written complaints of misconduct against judges, initiate complaints on its own motion, conduct investigations, file formal written complaints and conduct formal hearings thereon, subpoena witnesses and documents, and make appropriate determinations as to dismissing complaints or disciplining judges.<sup>482</sup>

The complaint process must be initiated by a written complaint which contains detailed charges of misconduct.<sup>483</sup> The allegations must be served on the accused judge, who is offered an opportunity for a formal hearing.<sup>484</sup> The proceedings are confidential and the Judiciary Law prohibits public disclosure by the Commission of the charges served, hearings commenced or related matters unless there

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475. *Id.* at R. 4(A), (B)(1).

476. *Id.* at R. 17 cmt.

477. *Id.* at R. 3(E)(3)(b).

478. *See id.* at R. 3(E)(3)-(4).

479. *Id.* at R. 11 cmt.

480. N.Y. STATE COMM’N ON JUDICIAL CONDUCT, *supra* note 473, at 54.

481. The Commission is designated in the New York State Constitution, which requires that four members be judges, at least one be an attorney, and at least two be laypersons. N.Y. CONST. of 1894, art. VI, § 22(a), (b)(1) (1961). The Commission elects one of its members to be chairperson and appoints an administrator and a clerk. N.Y. JUD. LAW § 41 (McKinney 2002).

482. N.Y. CONST. art. VI, § 22; N.Y. JUD. LAW § 44(1).

483. N.Y. JUD. LAW § 44(1).

484. N.Y. STATE COMM’N ON JUDICIAL CONDUCT, *supra* note 473, at 9.

is a waiver by the accused judge until the case has been concluded and a judgment rendered.<sup>485</sup> This differs from the Model Rules.<sup>486</sup> The Commission has broad decisional authority. If it determines that disciplinary action is warranted, it may render one of four sanctions: public admonition, public censure, removal of the judge from office, retirement for disability.<sup>487</sup> It also may issue confidential letters of dismissal and caution despite a dismissal of the complaint.<sup>488</sup> By privately calling attention to ethical violations which can be avoided in the future, the Commission serves an educational function, and is the only way by which the Commission may address a judge's conduct without making a matter public.<sup>489</sup> This is similar to the charity commission's proposed remedial role.

Since 1991 the Commission has averaged approximately 1400 complaints per year.<sup>490</sup> Fifty complaints were initiated by the Commission upon its own motion in 2000. In 2000, 1288 new complaints were received. Of these, eighty-four percent were dismissed by the Commission upon initial review, and 215 investigations were authorized.<sup>491</sup> There were 183 pending investigations from the previous year.<sup>492</sup> This is probably more than would be envisaged in a state-wide charities commission.<sup>493</sup> The Commission had a budget of \$1.9 million in 2000 with a staff of twenty-seven including six full-time and one part-time attorneys,<sup>494</sup> substantially more than projected for the charities commission.

The Commission on Judicial Conduct has existed in its present form since 1975,<sup>495</sup> and its size and caseload are substantially more

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485. N.Y. JUD. LAW §§ 44(4), 45.

486. MODEL RULES FOR JUDICIAL DISCIPLINARY ENFORCEMENT R. 11(a)(2) (1996).

487. N.Y. JUD. LAW § 44(7).

488. N.Y. COMP. CODES R. & REGS. tit. 22, § 7000.1(1), .3 (2002); N.Y. STATE COMM'N ON JUDICIAL CONDUCT, *supra* note 473, at 16.

489. N.Y. STATE COMM'N ON JUDICIAL CONDUCT, *supra* note 473, at 16. Pursuant to statute, the Commission's determinations are filed with the Chief Judge of the Court of Appeals. *Id.* There is a right of appeal to the Court of Appeals. *Id.* After dismissal of a complaint or a letter of conduct, if the behavior continues, the Commission may authorize an investigation on a new complaint. *Id.*

490. *Id.* at 1.

491. *Id.* at 2.

492. *Id.* at 3.

493. Of the combined 398 investigations from 1999 and 2000, 135 complaints were dismissed outright, 67 complaints were dismissed with letters of dismissal and caution, 7 complaints involving 7 judges were closed upon resignation of the judge, 6 complaints involving 4 judges were closed upon vacancy of office due to retirement or failure to win election, and 36 complaints involving 27 judges resulted in formal charges being authorized. *Id.* at 3.

494. *Id.* at 36.

495. N.Y. CONST. of 1894, art. VI, § 22 (1961).

than is envisioned by the charity commission. However, there are several commonalities. The Commission's primary goal is to instill respect for the judiciary. This is an important need for the nonprofit sector. The charity commission will offer a forum for complaints, which will be responded to more efficiently than under the current system. Both will preserve the confidentiality of the proceedings until guilt is established, thereby preserving the reputation of the innocent judge, in one case, and a nonprofit organization in the other. The confidentiality of the charity commission offers greater leeway to resolve problems and to protect innocent nonprofits. At the Commission on Judicial Conduct, the accused is protected from public disclosure until the case concludes, which is important as an overwhelming number of complaints are dismissed.<sup>496</sup> One can predict a similar result with the proposed charity commissions. A difference is that the charity commission as envisaged will be able to engage in more proactive resolution of problems.

*C. Charity Commissions as Catalysts of Normative Change of  
Fiduciary Behavior*

This proposal will bring a positive change in fiduciary behavior through education, publicity, and a change in normative consensus. The charity commissions will reach many organizations and their fiduciaries. Its educational functions and the fear of sanction by the attorney general will force many organizations on the behavioral margin who have been brought to the attention of the commissions to change their behavior and governance patterns. Most of these fiduciaries will understand their obligations and internalize them.<sup>497</sup> In due course, new social norms will emerge expressing a higher duty of fiduciary expectations. The charity commissions will encourage adherence to the social norm of following fiduciary rules by increasing the possibility of enforcement and extending the reach, though indirectly, of government investigation. Under Professor Sunstein's model, the attorney general will be a "*norm entrepreneur*" who may encourage a "*norm bandwagon*," that is a rapid and significant change in behavior.<sup>498</sup> Other norms scholars have "observed that the government may

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496. N.Y. JUD. LAW §§ 44-45.

497. Cf. Cooter, *Expressive Law & Economics*, *supra* note 177, at 585-86 (explaining that people tend to internalize sanctions imposed by law as moral values).

498. Sunstein, *Social Norms and Social Roles*, *supra* note 177, at 909 (defining "*norm entrepreneurs*" as "people interested in changing social norms" and "*norm bandwagons*" as "small shifts [in norms] lead[ing] to large ones").

be able to enhance compliance with the [new] law by changing or exploiting social norms rather than tinkering with sanctions."<sup>499</sup>

One area where the charity commissions could encourage new norms involves conflicts of interest. The commissions could encourage fiduciaries to establish conflict of interest policies, to sanitize interested transactions by requiring full, not material disclosure, and by encouraging nonprofits not to include the interested directors or officers for voting or quorum purposes. This could be achieved in a simpler, less expensive, and more effective way than the intermediate sanctions legislation. First, the organizations brought before the commissions would be taught, encouraged, or sanctioned to obey these norms. Second, cumulative reporting of the commissions' actions would give publicity to the new approach to conflicts of interest. Most desire to live up to the norms of society, but they have to know what they are. Publicity generated by the charity commissions will signify the seriousness of fiduciary breaches. The passive nature of board service and the casual attitude toward interested transactions will become things of the past as a new norm will have wide acceptance.<sup>500</sup>

### CONCLUSION

The proposed charities commissions offer an effective and efficient method of increasing resources of state regulators at a minimum cost. If successful, the charity commissions will signal that they are not principally enforcement arms but remedial bodies which will build trust and encourage people to report serious problems. They provide a channel for citizen action resulting from increased transparency provided by the internet. They will leverage the enforcement capacity of the attorney general and return the focus of regulation to a more local level involving interested citizens. Because of their breadth of remedial powers, charity commissions can educate charities and resolve minor problems. They offer a partnership between the nonprofit community and regulators, which avoids the problems of industry self-regulation that so often turns into self-protection. Accordingly, charity commissions can effectively restore the reputation of the nonprofit sector.

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499. Posner, *Tax Compliance*, *supra* note 178, at 1818 (citing to Lessig, *supra* note 177, at 960; Kahan, *supra* note 214, at 607; Sunstein, *Social Norms and Social Roles*, *supra* note 177, at 916).

500. The publication of the names of directors or of organizations might have a greater deterrence factor, but its stigmatizing effect would harm the organization and become counterproductive because individuals might not want to serve on boards and might hesitate to report potential abuses.